

A STUDY OF INFLATION IN PAKISTAN, 1955-1968

by

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ABSTRACT

Pakistan has experienced significant inflationary pressures in the course of her economic development. Although inflation was often repressed by Government controls, estimates based on free market prices existing alongside the controlled prices indicate that inflationary pressures have most of the time been quite significant. The price inflation has also been partly diverted towards the balance of payments pressure. Monetary expansion, caused by large deficit financing operations in the Government sector and bank financed development expenditures in the private sector, was often supplemented by substantial increases in income velocity. Nevertheless, monetary factors do not seem to have played as vital a role in generating the inflationary pressures as the structural factors like chronic food shortages and foreign exchange bottlenecks. Government's agricultural and commercial policies were greatly responsible for these shortages. Foreign economic aid and the P.L. 480 food imports relieved the general inflationary pressures considerably and played an important stabilizing role. Nevertheless, the pressure on prices and balance of payments has always been significant.

Evidence shows that inflation has not given much support to economic growth. Real savings and capital formation have <sup>not</sup> been so much encouraged by rising prices as by the availability of capital goods and raw materials. Profits have been mainly determined by the degree of competition rather than by the rising prices. On the whole, high rates of growth in the economy have been associated with low rates of inflation. On the other hand, inflation has

distorted the distribution of real income. Real wages have often been adversely affected by the rising cost of living and the brunt of inflation has been borne mainly by the working classes whose wages have risen very reluctantly in the process of inflation due to high unemployment and abundant supply of labour.

More stable economic growth in future would require sound agricultural development in future Plans and larger food supplies. Likewise, increased foreign exchange supplies both through exchange rate manipulations and foreign capital inflows together with relatively liberalized imports can ensure more efficient economic growth. Improvements in the fiscal and monetary management, lesser reliance on deficit financing and increased tax efforts would also be warranted in the interest of stable and efficient economic development.



## PREFACE

Inflation has currently assumed a global significance, affecting both the developed and the less developed areas of the world in varying magnitude. While the developed countries are confronted with the difficult task of maintaining full employment with price stability, the developing countries, committed to development programmes, are faced with the problem of maintaining high rates of economic growth with reasonable price stability. The purpose of this study is to analyze the inflationary pressures experienced by Pakistan in her process of planned economic development and to discuss the policy implications of current inflationary pressures.

It may be noted that a research worker analyzing the economic problems of a country whose statistical machinery is still rudimentary is painfully handicapped by the paucity of statistical data. One may also, at times, have to be a little sceptical about their reliability. Nevertheless, the available data have been used with care and conclusions have been drawn from them with caution.

Several debts have accumulated in the course of this study that must be acknowledged. I am deeply indebted to my supervisor Professor Edith T. Penrose for her very keen interest in my work and general help and encouragement throughout the course of this study. I was also greatly benefitted by my discussions with other members of the staff especially Mr. Peter Ayre, Mr. T.J. Byres and Dr. B. Dasgupta. In the end, I would like to thank the University

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## CHAPTER I

### INTRODUCTION

#### The Problem And Nature of Investigation

##### 1. Inflation And Economic Growth:

Most developing countries of the post-war world have experienced some inflationary pressures -- mild or strong. Inflationary pressures in these countries are often caused by wrong policies of governments and monetary authorities which result in monetary expansion at a faster rate than the rate of growth of real output and the demand for money. Pakistan has experienced inflationary pressures in her process of economic development which can, by no means, be termed as insignificant. The object of this study is to analyse the inflationary pressures in Pakistan since the beginning of systematic economic planning in 1955. Our attention would be focussed mainly on the assessment of the rate of inflation, examination of the policies of the Government and the monetary authority which led to inflationary pressures and the need for adopting a clear-cut price policy in the course of economic development.

In analyzing inflation in an under-developed economy, two schools of thought have developed, namely, the monetarist and the structuralist. The monetarists emphasize that the causes of inflation must be sought in the sources of excess demand. According to them, the development process in an under-developed country leads to monetary expansion at a faster rate than the rate of increase in real output and this causes inflationary pressures in the economy. This school considers the pressure of monetary demand

as the over-riding factor in inflationary pressures. They argue that the inflationary pressures whether generated by supply shortages, wage increases or in any other way cannot spread themselves into a general and sustained rise in prices unless monetary expansion takes place in the economy or income velocity rises. Supply factors may change the relative prices but a rise in general price level is purely a monetary phenomenon. Income velocity is, in itself, assumed to be greatly influenced by monetary expansion. If the rate of monetary expansion is high and money balances accumulate with the public in excess of what they wish to hold, spending will increase and this will influence the price level.

In analyzing the sources of monetary expansion in a developing economy, the monetarists have placed great emphasis on the role of budget deficits.<sup>1</sup> In an attempt to industrialize and develop, the governments of some under-developed countries have taken liberal resort to deficit financing and seriously unbalanced budgets have caused inflationary pressures. The monetarists insist that in a country where real resources are limited, inflation is very likely to be initiated if the government insists on securing additional resources without other sectors in the economy being willing to reduce their share.<sup>2</sup> The monetarists also stress the effect of government borrowings from the banking system on the expansion of private credit. It is realized that bank credit to

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1. See, for example, A.C. Harberger, "Some Notes On Inflation", in W. Baer and I. Kerstenetzky (Eds.), Inflation And Growth In Latin America (The Economic Growth Centre, Yale University, 1964), P. 322 and E. Gudin, "Inflation In Latin America", in D.E. Hague (Ed.) Inflation (London, 1962), P. 343.

2. Cf. E.M. Bernstein and I.G. Patel, "Inflation In Relation to Economic Development", I.M.F Staff Papers, Vol. 2 No. 3, 1951-52 P. 368.

the public sector will have secondary expansionary effects as a consequence of rising bank reserves. As inflation gets under way, the return from investment rises and rising profits induce enterprises to expand the scale of their operation. This is largely sustained through increased borrowings from the banking system. With regard to Chile, Tom E. Davis points out that in the course of inflation, the business sector develops a vested interest in credit expansion which comes to it at a very low or even negative real rate of interest.<sup>3</sup>

Thus the monetarists insist that excess demand, caused by excessive monetary expansion in the government and/or private sector, is the main cause of inflation in an under-developed economy. They admit the role of wages as transmitter of inflation but, in their analysis, a wage-price spiral does not play as important a role as in the structuralist analysis which we shall consider shortly. The monetarists are also not happy about the effect of inflation on the general economic development of a country. They believe that inflation leads to great waste of resources and produces distortions which, in the long-run might slow down or even stop economic growth (depending upon the intensity of inflation). Although no conclusive empirical evidence has been found to establish the adverse effect of inflation on economic growth, the case for inflation assisting economic growth is also not established.<sup>4</sup> It is, however, maintained that inflation induces forms of investment which do not make the highest possible contribution to growth in terms of increased

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3. Cf. Tom E. Davis, "Changing Conceptions Of The Development Problem: The Chilean Example", Economic Development And Cultural Change, October, 1965, P. 28.

4. Cf. R.J. Bhatia, "Inflation, Deflation and Economic Development", I.M.F. Staff Papers, Vol. VIII, 1960-61, P. 102; U.Tun Wai, "The Relation Between Inflation And Economic Development", I.M.F Staff Papers, October, 1959 and Graeme S. Dorrance, "Inflation and Growth: The Statistical Evidence", I.M.F Staff Papers, 1966 P. 91.

employment, production and standard of living. These investments include construction and stock-piling of goods.<sup>5</sup> The monetarists, therefore, suggest that economic development should proceed with price stability. With appropriate monetary and fiscal policies, economic development and price stability may be made mutually compatible.

The structuralist approach to the causes of inflation in a developing economy is in sharp contrast to the monetarist approach. They seek the causes of inflation basically on the supply side. It is argued that one must look for the real forces underlying the inflationary pressures rather than to treat them simply as a monetary phenomenon. Their analysis starts from the structural characteristics of an under-developed economy including the supply position of essential goods, import capacity of the economy and other real factors that might influence the price level. The structuralists claim to be realistic in the sense that they try to look beyond the monetary forces and the veil of money into the real structure of the economy and at such things as inelasticities of supply in the key sectors of the economy, import bottlenecks, downward rigidity of prices and wages etc. The monetary factors responsible for inflationary pressures like budget deficits and credit expansion are considered to be passive factors and treated as dependent on real factors. It is claimed that credit expansion and budget deficits adjust themselves to the changes in real situation in the economy.

The structuralists consider the structural deficiencies in the economy, factor immobilities and supply inelasticities as

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5. Cf. Graeme S. Dorrance, "The Effect of Inflation on Economic Development", I.M.F Staff Papers, 1963; R.A. Mundell, "Growth, Mobility And Inflationary Finance", Journal of Political Economy, April 1965 and Alexandre Kafka, "The Brazilian Stabilization Program, 1964-66", Journal of Political Economy, August 1967.

the basic cause of inflation. The food supply is specially considered to be stagnant in the face of rising demand in the course of economic development. In addition to lagging food supplies, bottlenecks may also be created in other ways. The difficulties of increasing and diversifying exports and export earnings, balance of payments difficulties and the resulting scarcity of imported goods, inadequate savings and capital formation and deficiencies in the tax system are some of the other factors responsible for generating inflationary pressures in an under-developed economy. The inflationary rise in prices may create demand for higher wages and if wages also rise they would be passed on to consumers in still higher prices. Rising food prices caused by a lagging agricultural sector are claimed to be the prime mover in inflationary pressures and are supposed to be the main source of wage-price spiral as food occupies a very important place in the total spending of under-developed countries.<sup>6</sup>

Economic development in under-developed countries increases demand in those sectors of the economy where bottlenecks prevent the expansion of supply. The demand for food often rises in the development process but the supply of agricultural products is rigid due to institutional factors. Often government's policy of agricultural price controls and over-valued exchange rate which affect agricultural exports also lead to the stagnation of agricultural sector. Food prices, therefore, rise and they affect the

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6. Cf. G. Maynard, Economic Development And The Price Level, ( Macmillan And Company, London, 1963, Chapter 3, PP 50-60; Dudley Seers, "A Theory Of Inflation And Growth In Under-developed Economies Based On the Experience Of Latin America", Oxford Economic Papers, June 1962; J.H.Olivera, "On Structural Inflation And Latin American Structuralism", Oxford Economic Papers, November 1964 and O.Sunkel, "Inflation In Chile: An Unorthodox Approach", International Economic Papers, No.10, 1960.

prices in other sectors of the economy through wage increases. Agricultural prices tend to respond more quickly than the prices of industrial products to changes in the balance between supply and demand and therefore their behaviour determines in large part the behaviour of the general price level. The structuralists also attach considerable importance to the instability of world demand for primary products and the consequent fluctuations in export earnings of underdeveloped countries. An upward swing in export earnings is likely to be accompanied by a rise in income and economic activity. But a downward movement in export earnings does not necessarily check the tendency to inflation. This is because, the worsening terms of trade may put pressure on prices and wages by reducing the real income and import capacity of the economy. Moreover, the fall in government receipts from taxation would necessitate credit creation with further inflationary effects. The effect of trade fluctuations on the economy of an under-developed country has, however, not been empirically established. The study undertaken by A.I. MacBean indicates that no significant correlation exists between short-term fluctuations in the export earnings of under-developed countries and their level of prices, investment and national income.<sup>7</sup>

The wage-price spiral plays an important part in propagating the inflationary pressures in the structuralist analysis but, on the whole, the structuralist approach is quite distinct from the traditional cost-push explanation of inflation.

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7. Cf. A.I. MacBean, Export Instability And Economic Development, (Harvard University Press, 1966).

In the latter, the inflationary pressures are initiated by labour's desire to acquire command over a large part of the real national income or at least to maintain its share in real terms. This brings a rise in money wages which tend to raise costs of production and lead to a further rise in prices. A wage-price spiral is, thus, generated. On the other hand, in the structuralist analysis, inflationary pressures are basically generated by structural deficiencies in the economy like the inelasticity of agricultural output, difficulties of foreign exchange, deteriorating terms of trade, balance of payments pressure and deficiencies of savings and capital formation. Once they are generated, then the role of wages becomes prominent in their propagation and wage-price spiral leads to a general inflationary situation in the economy.

In the structuralists' writings, there is much less stress on the undesirable effects of inflation than in the monetarist analysis. On the contrary, the structuralists consider inflation as a necessary concomitant of economic growth and, therefore, insist that it must be tolerated as such. According to them, an attempt to maintain price stability in under-developed economies would condemn them to a slow rate of growth, at best to the rate of growth of their export and agricultural sectors.<sup>8</sup> They also point out that inflation promotes forced savings and thus accelerates growth. It is assumed by them that substantial government investment is desirable in a developing economy in order to eliminate unemployment and under-utilization of capacity even though it may be financed by inflationary methods. Thus their main emphasis is on fostering

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8. Cf. R. Ruggles, "Summary of the Conference on Inflation and Economic Growth in Latin America", in W. Baer and I. Kerstenetzky (Eds.) Op.Cit.



economic development rather than on maintaining price stability. They consider inflation as a necessary price for rapid economic development though the possibility of curbing the inflationary pressures by removing supply rigidities in the agricultural sector, accelerating exports and reforming the tax system is not altogether excluded.<sup>9</sup>

It must, however, be pointed out that in spite of the distinction drawn between the monetary and structural factors exerting inflationary pressures in a developing economy, the fact remains that, in practice, the pressure on prices is always the combined effect of the monetary and structural forces. Quite often, the governments concerned chalk out ambitious development programmes which turn out to be inconsistent with the available resources for financing them and resort to deficit financing becomes inevitable. This causes inflationary pressures and excess demand conditions are created for both consumption and investment goods in the economy. At the same time, the structural deficiencies in the economy also contribute to the inflationary pressures generated by excess demand and the prices of those goods and services whose supply is relatively rigid rise at a significant rate. The inflationary pressures thus created culminate into a sustained and general rise in prices through wage increases. Thus, a sustained rise in the general price level over a specific period of time is often caused by some combination of monetary, structural and cost factors.

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9. Cf. J. Grunwald, "The Structuralist School On Price Stabilization And Economic Development" in A.O.Hirschman ( Ed. ) Latin American Issues, ( New York, 1961 ).



A price inflation may, however, be partly diverted towards the balance of payments pressure because balance of payments deficits are a way of supplementing the domestic output and of siphoning off the domestic inflationary pressures. Most developing countries, therefore, experience both a price inflation and a balance of payments pressure. In this study we shall study both the behaviour of prices in Pakistan and the balance of payments pressure during the period of planned economic development.

## 2. The Process of Growth In Pakistan:

Economic growth started in Pakistan around 1950 after some of the basic problems created by the partition of the Indian sub-continent had been overcome. The available data for this period show an average annual rate of growth of about 2.6 per cent in the pre-Plan period. The gross national product at constant factor cost (1949-50 to 1952-53 = 100) increased from Rupees 17,909 million in 1949 to Rupees 20,343 million in 1954-55. The per capita income also increased by about 1.6 per cent in the four years preceding the First Plan. The most spectacular development of this period was the growth of large-scale manufacturing industry. Income from this sector increased more than two-fold from Rupees 427 million in 1950-51 to Rupees 1002 million in 1954-55 while agriculture remained almost stagnant.

During the First Plan period ( 1955-60 ), the economy maintained an average rate of growth of about 2.5 per cent per annum and the real income increased only by 12.6 per cent over the Plan period against the Plan target of 15 per cent. On the other hand, the rate of population growth exceeded the Plan estimates and

virtually absorbed the rise in real income. The per capita income, therefore, remained almost stagnant. The employment situation also worsened in the Plan period as even new additions to the labour force could not be fully absorbed. While agriculture maintained a very poor rate of growth of 1.4 per cent per annum, industry maintained a compound rate of growth of about 10 per cent per annum.

Pakistan's Second Plan ( 1960-65 ) was a very ambitious Plan with more than double the proposed development outlays of the First Plan. The Plan aimed at raising the level of real income by 24 per cent. With a projected population growth rate of about 2 per cent per annum, the per capita income was expected to rise by over 13 per cent in the Plan period. The Plan claimed to create 3 million new job opportunities and to raise the export earnings by 15 per cent. The performance of this Plan was much better than the frustrated take off of the preceding Plan. The real income is reported to have increased by about 30.6 per cent over the Plan period against the target of 24 per cent. As the rate of economic growth far exceeded the rate of population growth, the per capita real income also increased by about 17.6 per cent over the Plan period. The employment opportunities available in this Plan were also large enough to absorb the 3.6 million addition to the labour force, though the initial unemployment remained unabated. This Plan had the advantage of drawing upon the experience of the preceding Plan and was also able to utilize the infra-structure built in the previous Plan.

The Third Plan ( 1965-70 ) was a still more ambitious Plan. It envisaged total development outlays of Rupees 52,000-

million that is, almost double the actual development expenditures of the Second Plan (which had substantially exceeded the proposed expenditures). The Plan aimed at raising the level of real income by 37 per cent over the Plan period with a compound rate of growth of 6.5 per cent per annum. With an estimated population growth rate of 2.6 per cent per annum, the per capita real income was expected to rise by about 24 per cent over the Plan period. The performance of this Plan was seriously affected by unexpected events like the armed conflict with India, cut-backs in foreign aid and crop failures. The productive capacity suffered due to these events and fixed investment declined from 18.8 per cent of the G.N.P in 1964-65 to 13.5 per cent in 1965-66. Even in the third year of the Plan, the rate of investment was only 14.5 per cent of the G.N.P. In the first two years of the Plan, the economic growth turned out to be below 5 per cent per annum. In the third year of the Plan, however, the economy maintained a high rate of growth of 7.5 per cent and the average for three years went up to 5.5 per cent. With a population growth rate of 2.7 per cent per annum, the per capita real income increased by about 8.5 per cent in the first three years of the Plan.

Most of the developing countries have only small domestic savings and their economic development is largely financed by domestic and external borrowings. Domestic credit expansion is often inflationary and this, coupled with the structural deficiencies and bottlenecks in the economy, often cause inflationary pressures. In Pakistan also, the domestic savings have significantly fallen short of capital formation and the difference has been made up by credit creation and inflow of external capital. In the First Plan

period, capital formation including fixed investment in public and private sectors and changes in stocks averaged about 10 per cent of the G.N.P. in current prices. On the other hand, the average rate of domestic savings was a little over 6 per cent of the G.N.P. The gap between investment and domestic savings was being financed by domestic credit creation and foreign capital inflows. The low level of domestic savings in this period was partly due to fiscal deficiencies and inability of the Government to raise additional tax revenues and partly to a sharp rise in prices which affected private savings by increasing spending. On the one hand, with a low level of tax revenues and high administrative expenditures, no public savings were possible and, on the other, due to a sharp rise in prices in the Plan period, consumption expenditures rose significantly and the public was therefore not able to make significant savings consistent with the rising level of money income.

As the real income increased substantially in the Second Plan period and foreign exchange position somewhat improved due to increased foreign aid inflows, both domestic savings and capital formation increased significantly. The ratio of domestic savings to gross national product in current prices rose from 6.5 per cent in 1959-60 to 12.6 per cent in 1964-65 and that of capital formation from 10.5 per cent to 18.8 per cent. In the Third Plan period, however, due to unexpected events, fixed investment declined from 18.8 per cent of G.N.P. in 1964-65 to 13.5 per cent in 1965-66. Even in the third year of the Plan, the rate of investment was only 14.5 per cent of the G.N.P. The average rate of domestic savings also

declined from 12.6 per cent of G.N.P in 1964-65 to about 9.6 per cent in 1967-68.

Tables 1, 2 and 3 show the over-all rate of growth in the economy during the period 1955-68 and the growth of industrial and agricultural output respectively. Chart 1 gives a graphic presentation of these variables. Table 4 presents the ratio of domestic savings and capital formation to the G.N.P and the excess of aggregate investment over domestic savings as a ratio to the G.N.P.

### 3. The Nature Of Investigation:

The present study is motivated by the fact that no elaborate study has so far been made on Pakistan inflation. Our objective in this study is to investigate the policy variables that gave rise to inflationary pressures in Pakistan in the process of economic development and to assess the gravity of the inflationary situation. Subsequently, we would also discuss the importance that should be given to price policy as a part of the general development policy.

It would be useful to review some of the related work done in the context of Pakistan inflation and to point out the lacuna that exists in this sphere. An earlier work of this kind is that of Parvez Hasan.<sup>10</sup> In this study the writer has shown that deficit financing in an under-developed economy like Pakistan would lead to an increase in real capital formation only if imported capital equipment and raw materials are available in adequate amount, otherwise it would simply lead to inflationary pressures. However, this is not a direct and an elaborate study of inflation and

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10. See Parvez Hasan, Deficit Financing And Capital Formation: The Pakistan Experience, 1951-59, ( Pakistan, Institute of Development Economics, Karachi, 1962. ).

TABLE 1Growth of G.N.P. and Per Capita Real Income, 1955-68

(Million Rupees)

Year	G.N.P. at Constant Factor Cost of 1959-60	Compound Rate of Growth %	Per capita Income at 1959-60 Prices	Compound Rate of Growth %
1955-56	27834	-0.3	308	-2.5
1956-57	29497	6.0	319	3.6
1957-58	29719	0.8	315	-1.3
1958-59	30144	1.4	312	-1.0
1959-60	31439	4.3	318	1.9
1960-61	33086	5.2	326	2.5
1961-62	35043	5.9	337	3.4
1962-63	36284	3.5	340	0.9
1963-64	39284	8.3	359	5.6
1964-65	41058	4.5	365	1.7
1965-66	42968	4.6	372	1.9
1966-67	45133	5.0	381	2.4
1967-68	48536	7.5	397	4.2

Source: Government of Pakistan, Economic Survey 1967-68,

Statistical Appendix, Table 1.

TABLE 2Index of Industrial Production, 1955-68

1953-54 = 100

Year	Index	Percentage Increase Over the previous Year.
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1954-55	127	-
1955-56	144	13
1956-57	152	6
1957-58	162	6
1958-59	182	12
1959-60	205	13

Revised Index 1959-60 = 100

1960-61	119	19
1961-62	139	17
1962-63	160	15
1963-64	181	13
1964-65	202	11
1965-66	214	6
1966-67	237	10
1967-68	261	10

Source: Government of Pakistan, Central Statistical  
Office, Monthly Statistical Bulletins.



TABLE 3Index of Agricultural Production, 1955-68

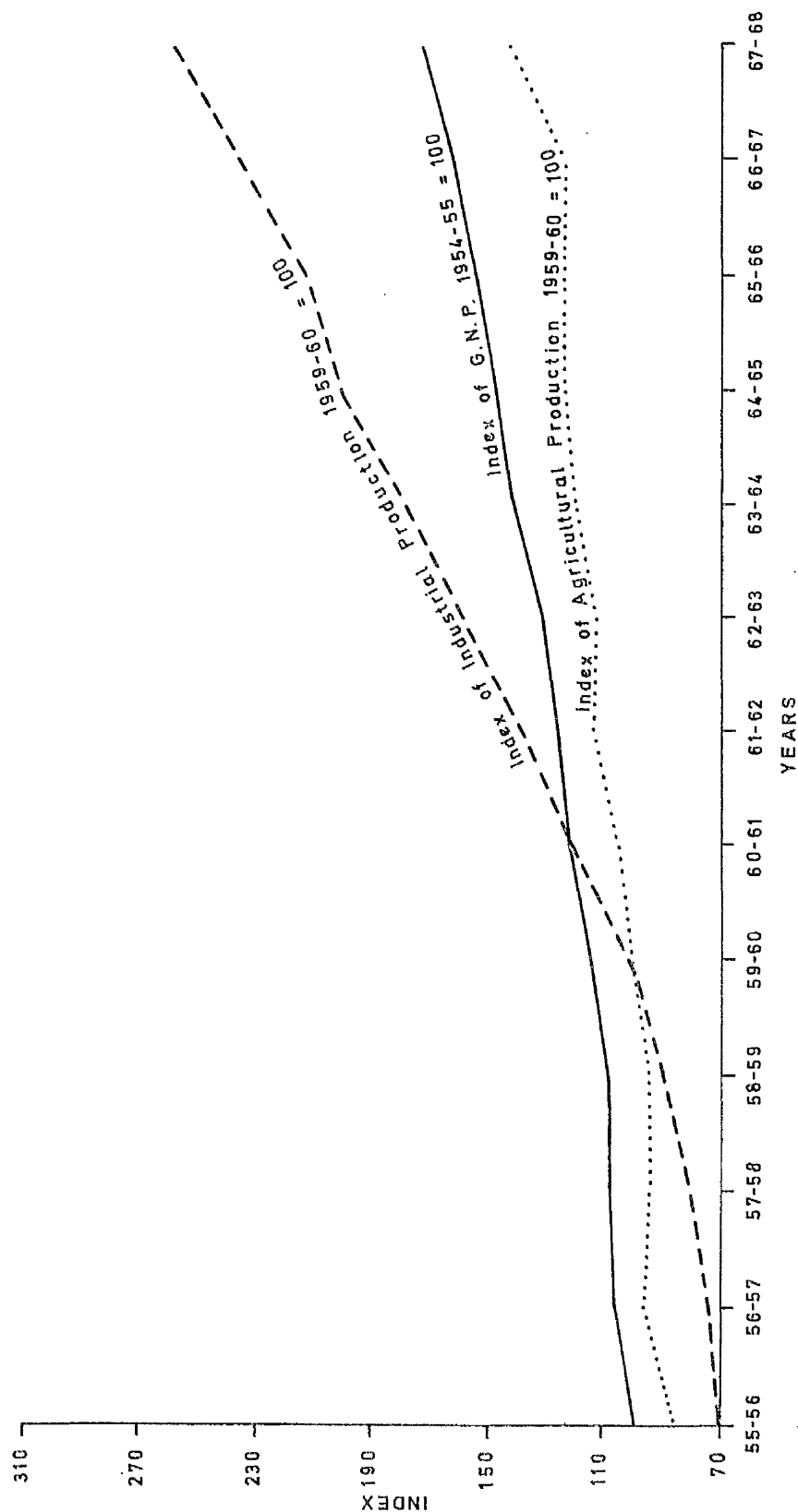
1959-60 = 100

Year	All Crops	Food Crops	Non-Food Crops	Fibres
1955-56	86	81	91	110
1956-57	96	96	94	102
1957-58	93	90	98	108
1958-59	93	88	111	103
1959-60	100	100	100	100
1960-61	105	107	100	91
1961-62	112	109	119	119
1962-63	111	105	137	119
1963-64	120	118	128	124
1964-65	123	121	143	112
1965-66	124	117	166	128
1966-67	123	112	175	134
1967-68	142	137	164	146

Source: Government of Pakistan, Central Statistical Office,  
Monthly Statistical Bulletins.



CHART I



INDEXES OF G.N.P. AGRICULTURAL AND INDUSTRIAL PRODUCTION

TABLE 4

Domestic Savings and Capital Formation as Percentage  
of G.N.P. (Current Prices)

Year	Capital Formation	Domestic Savings	Excess of Investment Over Savings as % of G.N.P.
1955-56	9.2	7.9	1.3
1956-57	8.2	4.5	3.7
1957-58	10.0	5.3	4.7
1958-59	9.7	6.1	3.6
1959-60	10.5	6.5	4.0
1960-61	12.7	8.9	3.8
1961-62	15.0	11.0	4.0
1962-63	16.6	12.1	4.5
1963-64	17.5	11.8	5.7
1964-65	18.8	12.6	6.2
1965-66	13.5	9.0	4.5
1966-67	13.3	8.2	5.1
1967-68	14.5	9.6	4.9

Source: Computed from data contained in The Second Plan,  
Evaluation Report of Second Plan and Mid-Plan  
Review of Third Plan, Statistical Appendices.

moreover it covers a different period than that covered by our study. Another study is the Pakistan Institute of Development Economics monograph: A Measure of Inflation in Pakistan, 1951-60.<sup>11</sup> This monograph gives an index of wholesale prices for East and West Pakistan and for Pakistan as a whole but does not render any analysis of the index and of the price behaviour in the country. Moreover, like the former study, this monograph also covers the period up to the First Plan period. R.C. Porter has also discussed some aspects of inflation in Pakistan in two consecutive papers but they again do not constitute a comprehensive study of price behaviour in Pakistan.<sup>12</sup> The present study is intended to fill up this gap and is designed to uncover all the aspects of Pakistan inflation and to discuss all the policy and non-policy variables exerting pressure on prices and balance of payments in the course of economic development.

Our approach in this study would be analytical but any sophisticated statistical and econometric techniques would not be employed because of the fact that the period covered by this study is short and the data are not very reliable while statistical manipulations are highly sensitive to the inaccuracies of data and the results drawn from them are apt to be misleading. We would, therefore, content ourselves with casual empiricism and presentation of the observed facts based on the writer's field work and experiences in Pakistan. Although the major source of information for the study

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11. See Pakistan Institute of Development Economics, A Measure of Inflation in Pakistan, 1951-60, ( Monograph no. 4, Karachi, 1961 ).

12. See R.C.Porter, "Income Velocity And Pakistan's Second Plan" , Pakistan Development Review, Vol.I, 1961 and "The Inflationary Implications Of Crop Failure", Pakistan Development Review, Spring, 1962.

is the published official statistics, considerable information has also been collected by the writer from various Government and research organizations in Pakistan and from interviews with businessmen, consumers etc.

The study covers the whole of the First and the Second Plan periods and first three years of the Third Plan but a background of the price behaviour in the pre-Plan period would also be given.

## CHAPTER II

### THE PRICE TRENDS IN PAKISTAN

Pakistan presents an interesting case study of inflation in a developing economy in the sense that here the inflationary rise in prices has typically coincided with the implementation of development plans. While the average price level in Pakistan was declining in the pre-Plan period, it began to rise at a significant rate in the First Plan period. Although inflation was officially repressed in this period through price and distribution controls on food and other essential commodities ( like cloth, petroleum, coal, iron and steel, cement etc. ) and administered prices recorded very little change, indices prepared from free market prices, which existed alongside the controlled prices, as controls were not very rigid, indicate a significant rise in the general price level in this period. The price and distribution controls on essential commodities including food-grains were imposed in 1953 following a poor crop which raised the food prices in 1952-53 and scarcity of other consumer goods which arose as a consequence of the imposition of import controls in August 1952 in the wake of seriously depleted foreign exchange reserves. However, these controls were not very effective and, in the case of food rationing, only urban centres and municipal areas were covered and even in these areas the public purchased a part of their requirements in the open-market. Thus, free market prices also existed alongside the controlled prices.

Most of the price and distribution controls were lifted in 1960-61 and a movement towards a freer economy was made. However, the price situation remained fairly stable during the Second Plan period as the economy maintained high rates of growth and domestic supplies were liberally supplemented by imports which were in turn made possible by the expanded foreign aid supplies and improved foreign exchange position. On the other hand, the food position had also improved by this time due to higher rates of growth in the agricultural sector and increased P.L. 480 food supplies. In the Third Plan period again there was a sharp rise in prices due partly to poor crops and partly to the acute shortage of foreign exchange caused by cut-backs in foreign aid at a time when scarce resources were being diverted towards armament and thus the over-all growth of the economy was adversely affected. We begin our study of prices with an examination of price movements in the pre-Plan period.

#### 1. Price Movements in the Pre-Plan Period:

The declining trend in the average price level in Pakistan in the pre-Plan period is indicated by almost all indices available for that period. First we consider a wholesale price index prepared by the Pakistan Institute of Development Economics which is based on free market prices. According to this index, the wholesale price level registered a decline of about 30 per cent from 100 in 1951-52 to 70.2 in 1954-55. The index shows a downward trend both in East and West Pakistan but there was a sharper decline in the former as compared with the latter mainly because the price of rice declined sharply in East Pakistan while the price of wheat was rising in West Pakistan except in 1954-55 when the wheat crop

was good. West Pakistan was facing a serious food shortage due to drought and locust swarms and therefore in spite of food control and rationing, the market price of wheat and other food-grains rose substantially. On the other hand, in East Pakistan, the food position improved a lot as a result of good crops. East Pakistan has always been a rice deficit area and the price of rice has remained high in that province but due to successive good crops, the rice prices began to decline and were at their lowest level in 1950 since the partition. The food position in East Pakistan remained fairly satisfactory thereafter and the price of rice maintained a declining trend, though the province continued to be a rice deficit area. Following a bumper crop at the end of 1953, the rice prices further declined and the province was able to build up an encouraging reserve and to declare a surplus area for export for the first time in its history. Moreover, the jute price also declined sharply after the Korean boom was over and these two crops largely determine the general price level in East Pakistan. As the weight assigned to rice in the East Pakistan index is greater than that assigned to wheat in West Pakistan ( 0.80 as compared with 0.24 ) the downward movement of East Pakistan price index in the pre-Plan period is more marked. The East Pakistan wholesale price index has always moved in the same direction and usually by about the same percentage as the price of rice. On the other hand, in the case of West Pakistan, although a change in the price of wheat almost always had a change in the index in the same direction, the amount of change was usually smaller<sup>1</sup>. Table 5 shows

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1. Cf. P.I.D.E., A Measure of Inflation in Pakistan, 1951-60, Op.Cit. PP.5-6.

the P.E.D.E. index of wholesale prices for this period.

In addition to the P.I.D.E index, other indices also indicate a declining trend in prices and cost of living in the pre-Plan period. Table 6 gives the following indices: (1) a simple average of the Central Statistical Office cost of living indices for industrial workers in selected centres of Pakistan, (2) the C.S.O consumer price index for government and commercial employees ( clerical ) in Karachi., (3) the implicit national income deflator and (4) the indices of import and export prices.

Unlike the wholesale price indices, which showed a clear downward trend in both wings of Pakistan, the cost of living indices moved in different directions. While the East Pakistan cost of living index declined by 16 per cent, that of West Pakistan rose by 4 per cent. The Central Statistical Office consumer price index for Karachi also rose by 1 per cent. The main reason for regional differences in cost of living were the widely differing food position and general availability of consumption goods in the two parts of the country. While West Pakistan was faced with a serious drought and food shortage, the food position in East Pakistan was much better and since food items have great weight in the consumer price and cost of living indices, this accounts for the difference in the movements of these indices.

There is a wide difference between the movements of the P.I.D.E wholesale price index and the C.S.O cost of living and consumer price indices. While the Institute's wholesale price index recorded a fall of 41 per cent in East Pakistan, the C.S.O cost of living index for Narayanganj ( E.P ) showed a decline of only 16



TABLE 5

P.I.D.E Index of Wholesale Prices, 1951-55

1951-52 = 100

Year	East Pakistan Price Index	West Pakistan Price Index	All Pakistan Price Index
1951-52	100.0	100.0	100.0
1952-53	96.4	114.2	105.3
1953-54	76.1	98.8	87.5
1954-55	58.7	81.7	70.2

Source : A Measure of Inflation in Pakistan, (Pakistan

Institute of Development Economics, Monograph

No. 4, March 1961, Table 1. p. 5.

per cent. Similarly, the P.I.D.E index recorded a decline of 18 per cent. in West Pakistan prices while the C.S.O cost of living index for West Pakistan recorded a rise of 4 per cent. This difference in sensitivity and movements of the indices is the result of differences in weights, prices used and goods covered. The inverse movements of the two indices in some years are primarily due to the difference between free and controlled prices. While the cost of living indices are based on controlled prices and have given more weight to such items as food, rent and services, the P.I.D.E wholesale price index is based on free market prices and weights included in it are derived from the amount of goods entering into the final use in each part of the country. Thus the C.S.O indices include the dampening effect of rents and services whose prices remained stable over the 1950's.

On the other hand, the implicit national income deflator shows a continuous decline of about 14 per cent in the pre-Plan period and its movements are similar to those of the P.I.D.E wholesale price index except in the year 1952-53. There was a sharp decline in export prices in that year following the Korean War boom and these prices are covered by the national income deflator whereas the wholesale price index is not directly influenced by them. Although both import and export prices were declining in the pre-Plan period, export prices declined more sharply than import prices and therefore the terms of trade deteriorated significantly.

Considering all the indices given above, it may be concluded that the average price level in Pakistan was declining in the pre-Plan period. Reasons for the declining trend in the price level were many. Although monetary expansion was fairly high in

TABLE 6  
COST OF LIVING AND OTHER INDICES 1951=55

Year	Cost of Living Indices		Consumer Price Index (Karachi)	National Income Deflator	Import Price Index	Export Price Index
	East Pakistan	West Pakistan				
1951-52	100	100	100	100	100	100
1952-53	104	111	102	94	82	59
1953-54	97	109	102	88	90	57
1954-55	84	104	101	86	86	60

Source: Central Statistical Office: Monthly Statistical Bulletins.

this period, it was being absorbed by the rising level of real income and wealth especially in the wake of rapid industrialization and the consequent increase in the demand for money. The money supply increased by about 41 per cent between June 1950 and June 1955 giving an annual average of about 8 per cent. Deficit financing was the major factor contributing to monetary expansion in this period. The net contribution of Government sector to the money supply was Rupees 1468 million while that of the private sector (adjusted for a shift to time deposits) was only Rupees 248 million. Almost 80 per cent of the over-all budget deficits of this period were met by bank borrowings and cash balance utilization. Credit expansion on private account was, however, low because private investment was still at a low level as foreign exchange difficulties proved to be a serious constraint on trade and investment. Table 7 shows the growth of money supply in this period and Table 8 gives its causative analysis.

On the absorption side, the average annual rate of growth was around 2.6 per cent, that is, even higher than in the First Plan period and this absorbed a substantial part of the monetary expansion. The gross national product increased by 13.6 per cent in real terms during the period 1949-50 to 1954-55. Although, agricultural production was stagnant in this period, industrial production increased at a fast rate though with a very low base. With the rising level of real income, the demand for real cash balances increased and, at the same time, the ratio of money to income also registered a rise of about 21 per cent representing a net decline in the income velocity of money. This can be accounted for partly in terms of <sup>the</sup> existence of direct economic controls which limited spending opportunities in the

TABLE 7Money Supply In Pakistan (In Million Rupees)1949-50 to 1954-55

Last Friday of June	Currency in Demand Deposits Circulation (General)	Other Deposits With State Bank of Pakistan*	Money Supply
1949-50	1691.8	999.9	36.8
1950-51	1987.0	1098.2	39.5
1951-52	2172.5	1045.2	37.7
1952-53	2172.8	1118.1	21.1
1953-54	2362.9	1201.8	20.1
1954-55	2556.3	1270.2	29.5

\* Excluding I.M.F. Account No. 1, Special Commodity Aid  
Accounts, I.B.R.D. Indus Accounts, etc.

Source: State Bank of Pakistan, Currency and Finance Reports.

TABLE 8

## Causative Analysis of Changes in Money Supply (In Million Rupees)

1950-51 to 1954-55.

Causative Factors	1950-51	1951-52	1952-53	1953-54	1954-55
Changes in Money Supply	+396.2	+130.7	+ 56.6	+272.8	+271.2
Domestic Private Sector	+ 59.8	+229.8	-124.4	+ 55.1	+ 27.8
Adjustment for Shift to Time Deposits	- 77.1	+ 34.5	- 61.0	-129.3	- 86.3
Net Private Sector	- 17.3	+264.3	-185.4	- 74.2	- 58.5
Govt. Sector	-151.8	+574.0	+619.6	+177.3	+248.9
Foreign Sector	+440.0	-672.7	-398.0	- 13.1	+ 70.8
Other Factors	+125.3	- 34.9	+ 20.4	+182.8	+ 10.0
Total Causative Factors	+396.2	+130.7	+ 56.6	+272.8	+271.2

Source: Government of Pakistan, Economic Survey, 1967-68, Table 14,

Statistical Section, pp. 28-29.

economy and partly in terms of the gradual monetization process in the <sup>is</sup>substance rural sector which increased the demand for money and facilitated the absorption of expanding money supply. The growth of money-income ratio in this period is shown in Table 9.

Internal credit expansion was also greatly cushioned by balance of payments deficits which followed the Korean War boom. The import controls were imposed in 1952 as a consequence of serious depletion of foreign exchange reserves accumulated during the trade boom, yet imports remained high and they greatly supplemented the domestic output. The deteriorating terms of trade in the post-Korean-war period also put pressure on the country's balance of payments. Large imports and balance of payments deficits served as a cushion for internal credit expansion. Table 10 and 11 present the terms of trade and the balance of payments position in this period.

## 2. The Inflationary Price Trends Since 1955:

In contrast to the declining price level in the pre-Plan period, Pakistan experienced a sharp rise in prices in the First Plan period. The price and distribution controls imposed in 1953 continued until 1960 and, in order to measure the rate of inflation in this period, the P.I.D.E index of wholesale prices would again be used though its movements would be compared with other indices as well. According to the P.I.D.E all-Pakistan index, the wholesale prices increased by 74 per cent in the First Plan period giving an average annual rate of increase of about 15 per cent. The rise was concentrated mostly in the first two years of the Plan for the reasons to be discussed later. East Pakistan experienced a sharper rise in the price level as compared with West Pakistan because of differences in the prices of basic foodgrains. While the price of

TABLE 9Changes in Monetary Ratio, 1950-51 to 1954-55

Year July-June	Money National Income (Million Rupees)	Money Supply (Million Rupees)	Monetary Ratio	Income Velocity
1950-51	20,740	3,125	0.150	6.66
1951-52	22,500	3,255	0.144	6.94
1952-53	21,802	3,312	0.152	6.58
1953-54	21,836	3,585	0.164	6.09
1954-55	21,147	3,856	0.182	5.49

Source: Computed from State Bank of Pakistan: Currency  
and Finance Reports.

TABLE 10Pakistan's Terms of Trade Position 1951-55

Price Indices 1951-52 = 100

Year	Export Prices	Import Prices	Terms of Trade
1951-52	100	100	100
1952-53	59	82	72
1953-54	57	90	63
1954-55	60	86	69

Source: Government of Pakistan, Central Statistical Office,  
Monthly Statistical Bulletins.



TABLE 11Balance of Payments Position and Foreign ExchangeHoldings of the State Bank of Pakistan

1950-51 to 1954-55.

(Million Rupees)

<u>Year</u> <u>July-June</u>	<u>Balance of Payments</u> <u>on Current Account</u>	<u>Gold, Dollar and</u> <u>Sterling Reserves</u> <u>(End of June)</u>
1950-51	+567.2	1513.1
1951-52	-463.6	1045.7
1952-53	-466.7	668.8
1953-54	- 59.7	630.5
1954-55	+ 9.9	696.4

Source: State Bank of Pakistan, Report on Currency andFinance, 1962-63, Table No. 1 p. 108.

rice in East Pakistan rose from Rupees 13.25 per maund in 1954-55 to Rupees 30.02 in 1959-60, the price of wheat in West Pakistan rose from Rupees 8.94 per maund in 1954-55 to Rupees 15.31 in 1959-60<sup>2</sup>.

On the other hand, the C.S.O index of wholesale prices covering only four years of the Plan namely 1956-57 to 1959-60 indicates a rise of only 5 per cent because of the fact that administered prices on which this index is based did not change much. Consequently, for measuring the inflationary pressures in Pakistan in the First Plan period, the C.S.O index does not serve much purpose as it conceals the inflationary situation prevailing in the economy. Table 12 gives the P.I.D.E and the C.S.O wholesale price indices.

The C.S.O. has also prepared the consumer and cost of living indices for the period under study. The consumer price index with 1959-60 base covers the consumption expenditures of government and commercial ( clerical ) wage earners at Karachi and industrial workers at four centres -- three in West Pakistan and one in East Pakistan. Commodity weights for this index were derived from a family expenditure survey conducted in 1955-56. On the other hand, the C.S.O cost of living index with 1948-49 base covers only industrial employees at the above mentioned four centres. Commodity weights for this index were based on a family budget enquiry made in 1944. The consumer price index shows a rise of 17 per cent in the First Plan period, giving an annual average of 3.4 per cent while the C.S.O cost of living index for industrial workers indicates a rise of 19 per cent. Difference between the movements of this

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2. Cf. P.I.D.E., Op.Cit, P.6.

TABLE 12Index of Wholesale Prices, 1955-68.

Year	P.I.D.E. Index 1951-52 = 100			C.S.O. Index 1959-60 = 100
	All Pakistan	West Pakistan	East Pakistan	All Pakistan
1955-56	88.3	93.2	83.4	Not available.
1956-57	115.1	112.0	118.2	95.4
1957-58	111.4	109.4	113.4	95.6
1958-59	115.4	113.2	117.6	93.9
1959-60	121.8	119.9	123.7	100.0
1960-61	"	"	"	103.0
1961-62	"	"	"	105.9
1962-63	"	"	"	104.8
1963-64	"	"	"	104.6
1964-65	"	"	"	112.4
1965-66	"	"	"	117.5
1966-67	"	"	"	133.9
1967-68	"	"	"	128.6
1968-69	"	"	"	136.0

Source: P.I.D.E. Monograph, No. 4, A Measure of Inflation  
in Pakistan, 1951-60 and C.S.O., Monthly Statistical  
Bulletins.

TABLE 13

C.S.O. General Consumer Price Index, 1955-68

1959-60 = 100

Year	Clerical Wage Earners, Karachi only.	Industrial Workers				
		Karachi	Lahore	Sialkot	Narayan ganj	Average of all Columns
1955-56	Not available	85.2	85.2	78.2	85.4	83.5
1956-57	92.8	90.7	92.0	87.3	89.4	90.4
1957-58	98.3	98.4	99.9	94.7	94.8	97.2
1958-59	95.7	94.6	93.5	92.2	95.7	94.3
1959-60	100.0	100.0	100.0	100.0	100.0	100.0
1960-61	102.8	101.8	107.0	108.4	100.7	104.1
1961-62	106.6	104.6	109.7	108.8	105.6	107.0
1962-63	106.7	103.2	108.0	106.9	107.2	106.4
1963-64	110.5	106.6	113.6	114.3	109.1	110.8
1964-65	116.9	112.9	119.7	117.0	113.8	116.1
1965-66	121.6	118.6	122.3	116.7	114.9	118.8
1966-67	130.8	129.1	134.9	132.5	126.1	130.7
1967-68	136.1	132.0	138.4	138.4	127.9	134.2

Source: C.S.O., Monthly Statistical Bulletin, September 1968.

TABLE 14

C.S.O. Cost of Living Index for Industrial Workers  
in Selected Centres

Base: April 1948 - March 1949 = 100

Year	Karachi	Lahore	Sialkot	Narayanganj	Average
1955-56	106.6	94.3	84.3	104.6	97.4
1956-57	113.4	101.7	94.1	109.5	104.7
1957-58	123.1	110.6	102.1	116.1	113.0
1958-59	118.3	103.4	99.3	117.3	109.6
1959-60	125.0	110.7	107.8	122.5	116.5
1960-61	127.3	118.4	116.9	123.3	121.5
1961-62	130.0	124.4	117.4	128.1	125.0
1962-63	128.0	120.3	114.6	132.4	123.8
1963-64	131.9	127.1	122.6	133.2	128.7
1964-65	139.0	135.9	125.1	139.9	135.0
1965-66	147.0	134.6	124.3	138.5	136.1
1966-67	162.1	143.8	142.2	156.1	151.0
1967-68	162.2	146.2	150.6	155.8	153.7

Source: C.S.O., Monthly Statistical Bulletin, September 1968.

TABLE 15The National Income Deflator and Other Indices

1954-55 = 100

Year	National Income Deflator	Index of Export Prices	Index of Import Prices
1955-56	106.9	118.8	138.0
1956-57	118.8	131.8	170.9
1957-58	125.4	143.4	168.5
1958-59	121.4	128.3	141.4
1959-60	132.0	126.5	157.8
1960-61	138.6	186.0	168.9
1961-62	137.3	156.0	160.4
1962-63	139.9	144.3	168.9
1963-64	138.6	141.2	159.4
1964-65	145.2	157.9	141.4
1965-66	151.8	158.5	167.6
1966-67	170.3	185.9	157.4
1967-68	167.6	162.1	159.6

Source : Computed from National Income data. Indices of  
 Export and Import have been taken from C.S.O.  
Monthly Statistical Bulletins.

index and the consumer price index is due to varying weights assigned to different items in the two indices. Tables 13 and 14 present these indices.

On the other hand, the implicit national income deflator, being a more comprehensive index, indicates a rise of 32 per cent in the First Plan period, giving an annual average of 6.4 per cent. The export and import prices also maintained an upward trend during the period under study. The import prices moved up at a faster rate than export prices in the First Plan period so that the terms of trade deteriorated significantly particularly in the first two years of the Plan because of rupee devaluation. Table 15 shows the movements of the implicit national income deflator and the export and import prices.

Several factors were contributing to the sharp rise in prices in the First Plan period. On the one hand, the deficit rate was high especially in the first three years of the Plan and this resulted in a high rate of monetary expansion. At the same time, income velocity also increased because of a sharp rise in public and private sector investment and consumption expenditures. On the other hand, availabilities were greatly limited due to a low rate of growth in the economy and restricted imports on account of seriously depleted foreign exchange reserves. Lastly, the devaluation of Pakistan's rupee raised the domestic prices of imports sharply in the first two years of the Plan. For all these reasons, the First Plan witnessed a sharp rise in the general price level.

In the Second Plan period, however, there was relative price stability in the country. The only index of wholesale prices available for this period is the C.S.O index. By 1961, the price and



distribution controls had been lifted and, therefore, changes in market conditions are fully reflected in this index. A modest rise of only 12.5 per cent has been recorded by this index for this period, giving an annual average of about 2.5 per cent. The price situation reflected considerable stability in the first four years of the Plan but the last year witnessed a rise of about 7.5 per cent in the wholesale prices. On the other hand, the C.S.O consumer price index and the cost of living index show a rise of 16 per cent, giving an annual average of about 3 per cent. The rate of increase shown by this index is a little higher than shown by the C.S.O index of wholesale prices because of the fact that it is heavily weighted for consumer items whose prices moved up relatively more than other prices in the economy. Like the C.S.O index of wholesale prices, the national income deflator also shows a modest rise of only 10 per cent, or 2 per cent per annum on an average. Although, monetary expansion was quite high throughout the Second Plan period both on account of large deficit financing in the public sector and credit creation for the private sector, the price situation, however, remained fairly satisfactory as the economy maintained high rates of growth and imports were greatly liberalized as a result of larger inflow of foreign aid and expanded P.L. 480 programme.

In the first year of the Third Plan, monetary expansion was exceptionally high on account of a sharp rise in deficit financing necessitated by a sudden rise in defence expenditure and curtailment in foreign aid. But income velocity declined very sharply in that year on account of the general depressing effects of Pakistan's war with India. The C.S.O index of wholesale prices then recorded a rise of about 5 per cent. In the following year, however, there was a



sharp rise in income velocity as the economy recovered from the effects of war and, at the same time, the food position worsened due to a severe drought in West-Pakistan and floods in East Pakistan. The C.S.O wholesale price index then recorded a rise of about 14 per cent. In 1967-68, the economy maintained a high rate of growth of 7.5 per cent and agricultural crops were good, this index then registered a decline of 4 per cent. The average annual rate of inflation shown by the C.S.O wholesale price index for the first three years of the Third Plan is thus 5 per cent as compared with 2.5 per cent recorded in the Second Plan period. The C.S.O consumer and cost of living indices also show a rise of 16 per cent in first three years of the Third Plan or about 5 per cent per annum on an average. Likewise, the implicit national income deflator also indicates a rise of 17 per cent in these three years. Both the export and import price indices maintained an upward trend in the first three years of the Plan but as import prices moved up more sharply, there was some deterioration in the terms of trade except in 1966-67 when they greatly improved.

The break-up of the C.S.O index of wholesale prices into different groups like food, manufactures, raw materials etc. is given in Table 16. This table indicates that food prices moved much more sharply over the period under study than other prices and they greatly contributed to the general inflationary pressures in the economy.

Since Pakistan has two distinct geographical regions, the price situation varies between the two wings of the country and this warrants a detailed regional study of price situation during the period under study. In fact, the entire study needs to be so planned as to analyze the price situation and the variables affecting it separately for each wing but the limitations of accurate data

TABLE 16C.S.O. Index of Wholesale Prices by Groups

1959-60 = 100

Year	Food	Raw Materials	Fuel, Lighting and Lubricants	Manufactures
1956-57	93.1	102.6	96.4	99.7
1957-58	92.8	103.2	99.2	102.1
1958-59	93.4	92.3	101.1	97.0
1959-60	100.0	100.0	100.0	100.0
1960-61	100.5	119.2	99.2	101.2
1961-62	106.6	107.3	98.7	102.1
1962-63	104.9	105.1	99.0	104.9
1963-64	104.3	105.3	104.5	105.8
1964-65	112.1	121.4	104.8	107.1
1965-66	117.3	125.2	108.5	113.4
1966-67	139.6	124.8	118.0	116.7
1967-68	134.7	106.4	120.0	120.0
1968-69	141.8	116.7	123.2	127.8

Source: C.S.O., Monthly Statistical Bulletins.

and information on certain important variables entering the analysis especially the money supply, impact of deficit financing on each province, credit expansion for private sector arising from each province, balance of payments for each wing etc. do not allow a separate study. Nevertheless as much regional information would be given in the study as possible.

The price situation in the two wings has been greatly determined by the relative food position in each wing. In a predominantly agricultural economy with the majority of population having a subsistence living, the foodgrains position has the greatest significance for the general price level and the cost of living. The foodgrains position is affected not only by crop conditions but also by expectations about them. A crop failure affects the foodgrains supply directly and also through speculative hoardings so that the marketable surpluses decline more than in proportion to the decline in output. This is because, while the small farmers try to maintain their consumption, the large farmers build up speculative foodgrain hoards in the hope of selling them later at higher prices. In rural areas, a part of the real balances are held in the form of foodgrain stocks and these stocks increase when food prices are rising<sup>3</sup>.

Generally speaking, the prices of rice and jute in East Pakistan and those of wheat and cotton in West Pakistan greatly influence the general price level. It must also be mentioned that because of a larger inflow of goods into East Pakistan from the Western wing, the inflationary pressures arising in the latter usually tend to spread themselves into the Eastern wing whereas those generated in East Pakistan often tend to remain confined to that province.

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3. Cf. R.C. Porter, "The Dangers of Monetary Policy in Agrarian Economies," Pakistan Development Review, Vol. I No.3, 1961 and "The Inflationary Implications of Crop Failure", Op.Cit.

### 3. The Price Situation In East Pakistan:

There was a sharp rise in prices in East Pakistan during the First Plan period as in the rest of the country. This is clearly shown by the P.I.D.E index of wholesale prices given in Table 12, though the C.S.O index given in Table 17 below tells a different story as it is based on controlled prices which were maintained by the Government through imports and subsidized distribution of foodgrains and other essential commodities. In addition to the effects of devaluation of Pakistan rupee in August 1955, Government's deficit financing operations and import restrictions, the province also suffered a food shortage caused by recurrent floods which sharply reduced the rice production especially in 1955-56 and 1957-58. With hardly any imports in 1955-56, the rice prices rose sharply in this and the following year from Rupees 13.25 per maund on an average in 1954-55 to Rupees 20.94 in 1955-56 and to Rupees 30.83 in 1956-57. However, crops were good in 1956-57 and this had a moderating effect on rice prices in 1957-58. Moreover, rice imports into East Pakistan also exceeded half a million ton both in 1956-57 and 1957-58. These, coupled with the subsidy on rice tended to stabilize the prices in 1957-58. But the crops were again badly damaged by floods in 1958-59. Moreover, the subsidy on rice was removed in that year and, therefore, the average retail price of rice again increased to Rupees 30.50 in 1958-59 and to Rupees 32.02 in 1959-60. In addition to food, there was also a sharp rise in cloth and yarn prices, sugar and other consumer goods in the First Plan period. The price controls were tightened by the military regime in 1958-59 and these brought down the cloth and consumer prices in that year but they rose again in 1959-60. The jute prices,

which were rising up to 1956-57 took a downward turn in 1957-58 as floods in the early season accelerated disposals by cultivators. In 1959-60, however, jute prices moved up as production declined and domestic consumption of raw jute by jute manufacturing firms increased. The wholesale price index which had taken a downward turn in 1957-58 <sup>and 1958-59</sup> rose again in the following two years. On the other hand, the cost of living indices maintained a constant upward trend throughout the First Plan period due to a serious shortage of food and other consumer goods in the province.

In the Second Plan period, however, there was a tendency for the prices to stabilize in East Pakistan as elsewhere. Although the province was hit by two cyclones, production of rice crop harvested in December 1960-January 1961 was at a record level of 9.5 million tons. The increased local production of rice in East Pakistan continued to be supplemented by despatches from West Pakistan and substantial imports from abroad. These factors contributed to keep the price of rice at a lower level during 1961 as compared to 1960. The jute prices, however, reached unprecedented levels in 1960-61, following a very small crop due to damage caused by floods. But the effect of this on the general price level was greatly neutralized by a substantial reduction in rice prices. In 1961-62 again the level of rice output remained high and rice prices remained more or less unchanged but jute prices subsided to more normal levels in that year as a large crop was marketed. The cost of living, however, continued to rise throughout the Second Plan period despite Government's efforts to hold it. Cost of living index at Narayanganj (E.P.) increased from 122 in March 1960 to 128 in March 1962 and continued to rise till June when it reached 133. This was largely due to

increases in the food, clothing and miscellaneous groups. But in the second half of the year not only the upward trend was arrested but there was some decline and the index fell to 130 in December which, however, was four points higher than in the beginning of the year. The price of rice which was sharply affected by a bad harvest and later by flood damage to crops was kept in check by the supply of large quantities from Government stocks and by a large increase in imported wheat from the United States. Yet, the cost of living did not get much support because wheat is consumed in very small quantities in East Pakistan. The cost of living for industrial workers at Narayanganj further increased from 128 in March 1962 to 129 in March 1963.

Unlike 1962-63, the rice crop was exceptionally good in 1963-64. The average wholesale price of medium quality rice at Dacca dropped from Rupees 34.00 per maund in July 1963 to Rupees 32.38 per maund in December due to the arrival of new crops. The all-Pakistan wholesale price index for rice ( 1959-60 = 100 ) rose from 95.6 in 1961-62 to 103.0 in 1962-63 but dropped to 80.25 in March 1964. The cost of living index for industrial workers at Narayanganj however, continued to rise and moved up from 129 in March 1963 to 131 in March 1964. This was due to the general shortage of housing, transport and consumer goods and rise in their prices.

On the whole, the price situation remained satisfactory till the middle of 1964 but inflationary forces tended to become assertive thereafter and caused concern to the Government and the people alike. The wholesale price index ( 1959-60 = 100 ), which had not changed much in the first four years of the Plan jumped from 102.6 in 1963-64 to 111.3 in 1964-65. The rice crop in 1964-65 was marginally smaller than in 1963-64 but it exceeded the Plan target by 12.7 per cent. The

price of rice, therefore, remained easy during 1964-65 as in 1963-64. However, the over-all price rise was quite significant in that year due to large monetary expansion and rise in income velocity which reflected the increased tempo of development activity in the province. Nevertheless, in the Second Plan period, as a whole, the general level of prices remained stable despite accelerated development expenditures in the province. This was mainly due to improved food position during the period and liberalized imports of raw materials and finished products. The general wholesale price index increased by only 2.2 per cent annually on the average. The present structure of the economy is such that food prices are the most important determinant of the general price level. Hence, increased availability of food has been the main factor behind relative price stability in the Second Plan period while monetary factors played only a secondary role in determining the price level.

By contrast, the first year of the Third Plan showed a substantial rise in the general price level which increased by about 10 per cent during 1965-66. This was again due to a slight deterioration in domestic production of rice and dislocation of import trade due to Pakistan's war with India in September 1965. The war resulted in lower volume of imports including raw materials and necessitated additional taxation in the form of import surcharge, thus increasing the prices of imported commodities. Increased defence expenditure also worked in the same direction. The rice price remained high during 1965 and the monthly average wholesale price at Dacca ranged between Rupees 26.45 and Rupees 36.87 per maund compared to Rupees 22.44 and Rupees 31.25 per maund during 1964. The rise was mainly due to tight supply position. The devastating cyclone of May 1965



caused widespread damage to standing crops. The price of rice further rose when hostilities broke out with India and both internal and external communications were adversely affected.

The year 1966-67 saw a further deterioration in the price situation. The general wholesale price index rose by about 15 per cent. Once again, availability of food was mainly responsible for this rise. Domestic production of rice recorded a substantial fall due to adverse weather conditions, leading to a rise in the price of rice. The food price index rose from 122.6 in 1965-66 to 148.5 in 1966-67 due partly to bad crops and partly to restricted availability of foodgrains under the P.L. 480 programme. The availability of other consumer goods was also reduced by the restrictions on imports necessitated by a long delay in the receipt of foreign economic aid and the diversion of a large part of the country's foreign exchange resources to food import. Between April-October 1966, the wholesale price index increased by 24.1 points. During the period November 1966 to March 1967, however, it declined by 6 points. The average wholesale price of rice remained high during that year. From July 1965 to March 1966, the average wholesale price of rice at Dacca ranged between Rupees 28.27 to Rupees 36.87 per maund but the corresponding figures for the period July 1966 to March 1967 were Rupees 37.00 to Rupees 48.50 per maund. The general consumer price index ( 1959-60 = 100 ) at Narayanganj rose from 114.9 to 126.1. The sharp increase in prices in that year was mainly due to a substantial increase in food prices though the monetary factors, especially a rise in income velocity also contributed to it.

There was a substantial improvement in the price situation in 1967-68 due to a large increase in the domestic production of rice leading to a decline in food prices. The wholesale index of



food prices declined from the 1966-67 average of 148.5 to 135.6 in 1967-68 while the general wholesale price index declined from 141.5 to 129.7. The index of raw material prices also fell from 122.5 to 107.1. On the other hand, the consumer price index for industrial workers at Narayanganj ( 1959-60 = 100 ) rose from 114.9 in 1965-66 to 126.1 in 1966-67 and to 127.9 in 1967-68. The rise in cost of living in 1967-68, despite a fall in general price level especially in food price index, may be attributed partly to the rise in the Government issue price of both rice and wheat<sup>e</sup> in that year and partly to a rise in the prices of other main heads of expenditure comprising the consumer price index. The downward trend in prices in 1967-68 was, however, reversed in the last quarter of the year. The wholesale price index rose sharply thereafter both in East and West Pakistan but more markedly in East Pakistan. The rise in prices was partly due to end season shortages of food and the consequent rise in food prices. The wholesale price index again moved up to 141.1 in 1968-69 and its movement was sharper in East Pakistan than in West Pakistan. On the whole, the increase in the general price level during the first three years of the Third Plan was more pronounced in the Eastern wing than in the Western wing. In both parts of the country the price increases were mainly in food items, fuel, lighting and lubricants group and manufactures.

Table 17 presents the C.S.O indices of wholesale prices for East Pakistan.

#### 4. The Price Movements in West Pakistan:

The First Plan period was a period of almost continuous pressure on prices in West Pakistan as well. On the one hand, there were recurrent floods from 1955 to 1957 which created serious food

shortages that were partially alleviated by a high rate of imports after the middle of 1956. Despite this, the wholesale prices of wheat in important centres of West Pakistan rose by about one-third over the 1954-55 level. Imports of other consumer goods were also severely restricted due to dwindling foreign exchange reserves. On the other hand, monetary expenditures were rising rapidly both in the public and private sectors. Deficit financed development expenditures of the Central Government were higher in this province and they created inflationary pressures. Moreover, the devaluation of 1955 raised the domestic prices of export products like cotton, wool etc. and thus increased agricultural incomes, giving a push to consumption expenditures. At the same time, the rupee prices of imported commodities also went up. The net result was rising prices and cost of living in all parts of the province. In 1957-58, however, there was some decline in wholesale prices as export prices receded. The wholesale price of cotton, the major export from West Pakistan, especially declined by about 10 per cent. The consumer and cost of living indices, however, maintained an upward trend as import restrictions were further tightened and retailers were able to make large profits. The military government which took over in October 1958, tightened direct economic controls and brought profiteers and hoarders to books. Large stocks of consumer goods were then brought to the market and prices showed a marked decline. But the effect of these restrictions lasted only a few months and on the whole during 1958-59 there was again some rise in prices especially in the free market prices which emerged soon after the restrictions were relaxed. However, the C.S.O wholesale and consumer price indices show a decline in that year as they are based on controlled prices. Both the central and provincial budgets for 1958-59 introduced

TABLE 17C.S.O. Index of Wholesale Prices for East Pakistan

1959-60 = 100

Year	General	Food	Raw Materials	Fuel, Lighting and Lubricants	Manufac- tures.
1956-57	100.9	99.9	108.8	93.7	99.4
1957-58	96.0	95.1	92.4	95.8	109.3
1958-59	94.5	96.5	80.6	99.2	97.5
1959-60	100.0	100.0	100.0	100.0	100.0
1960-61	102.8	96.5	136.7	99.7	107.3
1961-62	106.8	108.0	101.7	99.7	105.4
1962-63	106.2	108.4	96.0	100.1	102.8
1963-64	102.6	104.0	94.0	105.7	102.1
1964-65	111.3	111.5	113.9	103.6	107.0
1965-66	122.8	123.6	124.7	106.7	115.5
1966-67	141.5	148.4	122.5	111.0	115.7
1967-68	129.7	135.6	107.1	111.5	115.9
1968-69	141.1	147.1	122.2	113.2	122.1

Source: C.S.O., Monthly Statistical Bulletins.

several new taxes but as deficit financing still continued, though in a restricted form, over-all inflationary forces continued in the economy. Moreover, shortages of different kind also continued to be felt as imports were severely restricted by the new regime in an attempt to cope with the seriously depleted foreign exchange reserves and hoarding and profiteering re-emerged. In 1959-60, there was again a sharp rise in prices and cost of living. In May 1960, the Government decided to decontrol foodgrain marketing and the issue price of imported wheat was raised from Rupees 14 to Rupees 18 per maund. This, coupled with a drought and reduction in domestic production of wheat raised the food prices by about 40 per cent. However, increased sale of imported wheat gradually brought back the rise in food prices to about 20 per cent after decontrol. During 1958-59 and 1959-60, the annual import of wheat was as high as 900 thousand tons. On the whole, during the First Plan period, inflationary pressures were less severe in West Pakistan than in East Pakistan because of larger food supplies.

There was relative price stability in the province during the Second Plan period. The decision to decontrol was extended to cotton textiles and other consumer goods in 1961 and therefore there was some rise in prices in 1960-61. But as imports were liberalized, following the increased foreign aid inflows and improved foreign exchange supplies, industrial production increased substantially and therefore the pressure on prices was greatly alleviated. The year had a fairly good foodgrains harvest and this, coupled with large imports of wheat in 1960 and 1961 brought the food prices down, which had risen significantly after decontrol. There was a bumper wheat crop in 1961-62 and imports also remained high especially after the conclusion of a commodity agreement with the United States

under which Pakistan was to receive wheat worth \$ 621 million during 1961-62 to 1964-65. The Government then reduced the release price for imported wheat to Rupees 14 per maund in 1962 and the prices of domestic wheat also dropped below the support levels in some areas. The cost of living, however, increased in all important centres of West Pakistan both in 1960-61 and 1961-62 due to decontrol and the rising cost of transport, housing and other services. In 1962-63, however, there was a general decline in the cost of living in West Pakistan mainly due to improved food position and a further decline in wheat prices. The index of wheat prices ( 1959-60 = 100 ) declined in West Pakistan from 114.9 in 1960-61 to 106.61 in 1961-62 and to 101.43 in 1962-63. The cost of living index for Karachi, which rose from 130 in January 1962 to 132 in February came down to 127 by the end of December 1962. In March 1963, however, the indices stood at 129 at Karachi and 123 at Lahore.

The price of wheat during 1963-64 was generally higher than in the previous season. The issue price of imported wheat was raised in West Pakistan from Rupees 14 to Rupees 15 per maund in April 1963 and in East Pakistan from Rupees 12.50 to Rupees 15 per maund in November 1963. Import of wheat from the United States under P.L. 480 programme continued to meet the food gap in West Pakistan and also to improve the critical food situation in East Pakistan following a serious damage to the rice crop due to drought and later floods. The wholesale price index for wheat ( 1959-60 = 100 ), which had come down from 114.90 in 1960-61 to 106.61 in 1961-62 and to 101.43 in 1962-63 rose again to 112.12 in 1963-64. The cost of living index at different centres of West Pakistan, therefore, rose significantly during the year but the general wholesale price index remained almost

unchanged. The cost of living index ( 1948-49 = 100 ) increased at Lahore from 120.3 in 1962-63 to 127.1 in 1963-64.

The price of wheat moved up very sharply in 1964-65, the index rising from 112.12 in 1963-64 to 122.53 in 1964-65 due to poor crops. The C.S.O. index of wholesale prices then showed a marked rise in West Pakistan from 106.4 in 1963-64 to 113.6 in 1964-65. The upward trend was most marked in raw materials and food groups. The prices of fuel, lighting, lubricants and manufactures, however, remained fairly steady. Later, in view of the prospect of a good crop in April-May, prices began to decline and in March 1965 stood at Rupees 18.51 per maund, the same as in March 1964. In East Pakistan, however, wheat was available at the subsidized rate of Rupees 12.50 per maund during 1964 and in the first quarter of 1965. The price was kept low in order to popularise its use in that province. As a result of the sharp rise in food prices in West Pakistan, the cost of living further moved up at all centres of the province.

Due to a bumper wheat crop in May 1965 and liberal import of wheat, the wheat prices declined sharply during the fiscal year 1965-66. The index of wheat price in West Pakistan declined from 122.53 in 1964-65 to 111.66 in 1965-66. The general index of wholesale prices in the province also moved down a little. However, due to Pakistan's war with India in September 1965 which resulted in a serious shortage of consumer goods on account of restricted imports coupled with a high rate of deficit financing, the general consumer price index for industrial workers increased in almost all centres of West Pakistan and more particularly at Karachi. In the following year, however, there was a very sharp rise in prices in the province as in the rest of the country. On the one hand, there was a serious fall in wheat production because of a drought in West Pakistan.

Moreover, there was a reduction in the availability of foodgrains under the P.L. 480 programme because of the changed United States policy towards aid to Pakistan. The index of wheat prices in West Pakistan, therefore, jumped to 168.48 from its previous year's level of 111.66 per maund. The average wholesale price of wheat started rising after July 1966 and the price quoted at Rupees 17.42 per maund at Lyallpur ( an important wheat market in West Pakistan ) rose to Rupees 24.12 in November 1966. At the same time, the availability of other consumer goods also continued to be limited by import restrictions necessitated by a long delay in the receipt of foreign economic aid and diversion of scarce foreign exchange towards the import of foodgrains. The index of wholesale prices in West Pakistan, therefore, jumped from 112.0 in 1965-66 to 124.4 in 1966-67. The consumer price index ( 1959-60 = 100 ) also jumped from 118.6 to 129.1 at Karachi and from 122.3 to 134.9 at Lahore.

The effect of food shortage in 1966-67 continued for most part of 1967-68 as well. However, there was a good crop in April-May that year and the P.L. 480 food imports were also restored to their former level. Foodgrain imports from Pakistan's own foreign exchange earnings were also high and, therefore, the price situation was greatly eased. The index of wheat prices in West Pakistan declined from 168.48 in 1966-67 to 149.10 in 1967-68. The general index of wholesale prices also displayed a continuous declining trend during the year. It stood at 130.29 in March 1967 but declined to 124.34 in March 1968. As in East Pakistan, the sharpest decline in West Pakistan occurred in the prices of raw materials. The index for the food group was, however, lower in West Pakistan than in East Pakistan. The declining trend in general price level and cost of living had started since May 1967. This continued up to March 1968 but prices started

rising again from April 1968. Between April and November 1968, the wholesale price index increased rather sharply. The rise in prices was partly due to the end season food shortages and the rise in food prices. The wholesale and consumer price indices rose more sharply in 1968-69 and more markedly in East Pakistan than in West Pakistan. The long prevailing disparity between prices in East and West Pakistan ( the former experiencing more inflationary pressures than the latter ) continued almost at the same ratio in the first three years of the Third Plan.

Table 18 gives the C.S.O indices of wholesale prices in West Pakistan and Table 19 gives the break-up of these indices for important commodities in both wings. Chart II graphically presents the inflationary price trends in Pakistan during the period under study.

##### 5. The Over-all Rate of Inflation:

On the whole, each of the above mentioned indices tells a somewhat different story about the rate of inflation in Pakistan. For the First Plan period, the P.I.D.E index based on free market prices indicates the sharpest rise as compared with other indices. Next to this, the implicit national income deflator also shows a fairly sharp rise because of the fact that it is a broad-based index covering a large variety of prices including the most sensitive ones. For the Second Plan period, however, all indices indicate relative price stability. But for the first three years of the Third Plan all indices again show a sharp rise in prices as compared with the Second Plan period. Considering the movements of implicit national income deflator and the C.S.O indices, the average annual rate of inflation in Pakistan during the period under study works out to a little over 5 per cent. But when the movements of the P.I.D.E



TABLE 18C.S.O. Index of Wholesale Prices for West Pakistan

1959-60 = 100

Year	General	Food	Raw Materials	Fuel, Lighting and Lubricants	Manufac- tures
1956-57	90.0	83.4	98.8	97.6	99.8
1957-58	95.4	89.4	109.9	100.6	99.8
1958-59	92.8	88.9	99.6	101.9	96.8
1959-60	100.0	100.0	100.0	100.0	100.0
1960-61	104.8	106.3	108.2	99.0	99.2
1961-62	104.7	104.7	110.8	98.3	101.0
1962-63	102.9	99.9	110.6	98.5	105.6
1963-64	106.4	104.6	112.4	103.9	107.1
1964-65	113.6	113.1	126.0	105.3	107.2
1965-66	112.0	108.2	125.6	109.2	112.7
1966-67	124.4	126.9	126.2	120.9	117.0
1967-68	126.0	133.3	106.0	123.6	121.7
1968-69	129.5	134.0	113.2	127.4	129.8

Source: C.S.O., Monthly Statistical Bulletins.

TABLE 19

Index Numbers of Wholesale Prices by Commodities, 1959-60 = 100

YEAR	RICE		WHEAT		FISH		EGGS	
	E.P.	W.P.	E.P.	W.P.	E.P.	W.P.	E.P.	W.P.
1956-57	105.3	93.9	110.3	94.8	80.6	87.1	95.5	94.5
1957-58	93.1	109.3	110.3	95.2	101.1	181.5	99.5	93.8
1958-59	95.9	102.0	102.5	95.6	102.6	92.6	91.2	96.0
1959-60	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1960-61	91.0	95.3	97.4	114.9	105.3	90.3	116.6	112.6
1961-62	95.5	96.3	91.5	106.6	116.1	98.6	120.6	113.7
1962-63	103.5	96.0	65.5	101.4	112.5	94.7	121.9	123.1
1963-64	92.1	100.6	72.3	112.1	123.3	112.8	123.9	157.2
1964-65	95.7	102.6	65.4	122.5	146.0	112.1	128.7	166.4
1965-66	113.7	98.8	71.6	111.6	137.9	112.2	131.2	159.6
1966-67	148.1	112.6	98.9	168.4	144.3	116.7	141.7	178.6
1967-68	130.5	125.7	111.0	149.1	138.4	117.8	158.5	176.7

TABLE 19 (Continued)

Index Numbers of Wholesale Prices by Commodities, 1959-60 = 100

YEAR	<u>MEAT</u>		<u>MILK</u>		<u>TEA</u>		<u>JUTE</u>	
	E.P.	W.P.	E.P.	W.P.	E.P.	W.P.	E.P.	W.P.
1956-57	94.8	88.4	80.0	77.7	63.9	73.8	125.6	--
1957-58	98.0	92.7	82.9	81.4	77.1	79.0	101.5	--
1958-59	102.6	98.4	76.8	87.4	80.4	81.3	77.9	--
1959-60	100.0	100.0	100.0	100.0	100.0	100.0	100.0	--
1960-61	105.0	104.5	101.0	107.4	76.6	93.0	219.8	--
1961-62	109.7	111.8	99.7	105.6	72.3	91.4	119.8	--
1962-63	112.8	110.9	97.6	106.6	115.9	113.9	103.1	--
1963-64	115.4	117.2	92.3	105.7	83.9	108.2	103.5	--
1964-65	134.2	119.1	103.7	110.3	92.5	101.1	141.2	--
1965-66	141.7	125.7	102.5	114.2	131.9	118.8	149.1	--
1966-67	151.6	133.6	109.5	118.5	117.4	130.3	159.2	--
1967-68	157.7	158.1	112.3	128.9	103.2	108.7	129.4	--

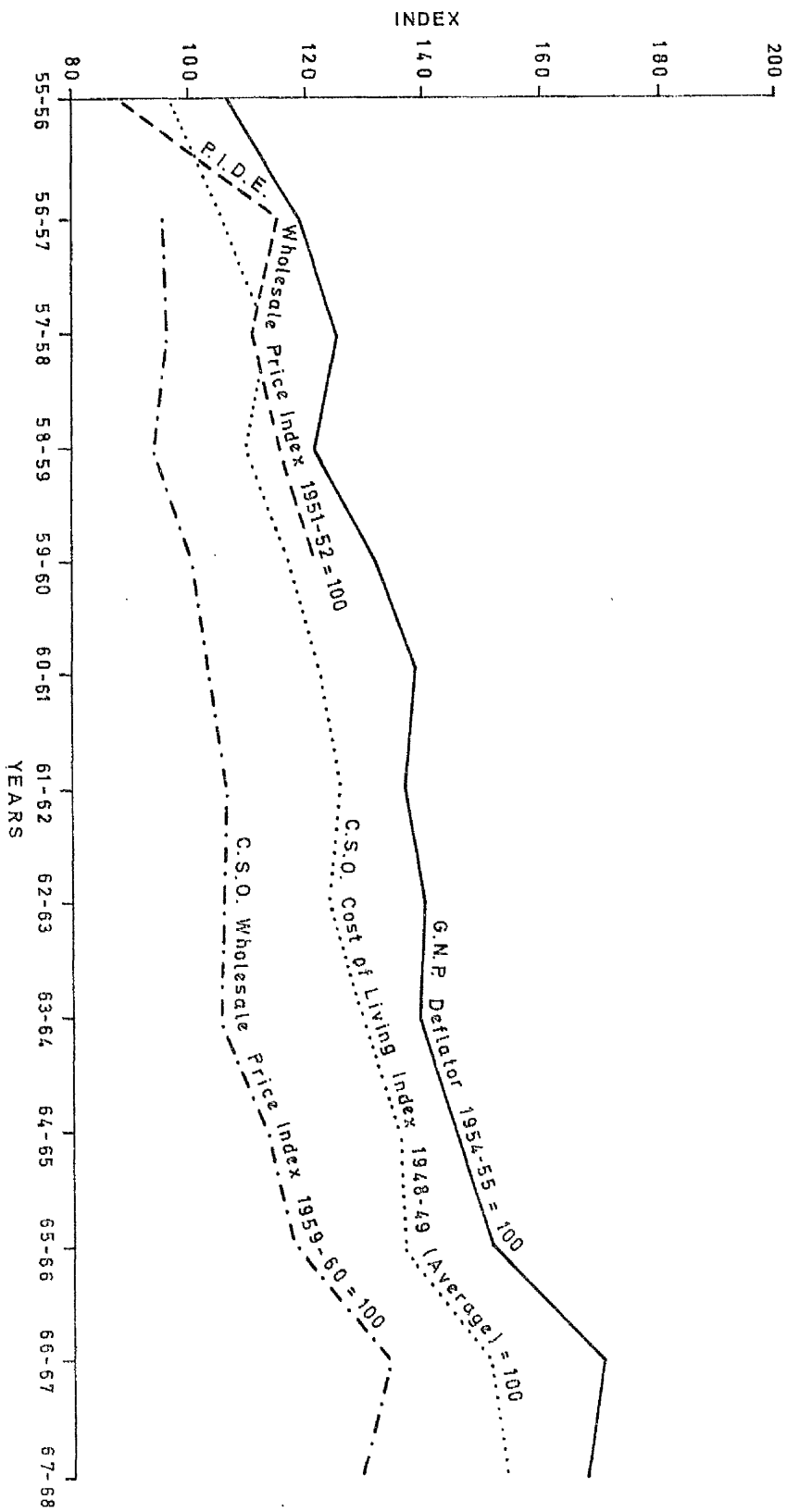
TABLE 19 (Continued)

Index Numbers of Wholesale Prices by Commodities, 1959-60 = 100

YEAR	COTTON		COTTON MANUFACTURES		JUTE MANUFACTURES	
	E.P	W.P	E.P	W.P	E.P	W.P
1956-57	119.68	98.2	82.9	98.2	91.8	83.6
1957-58	94.2	96.7	86.5	91.8	87.8	78.4
1958-59	86.4	86.2	95.7	87.4	79.9	72.9
1959-60	100.0	100.0	100.0	100.0	100.0	100.0
1960-61	128.2	108.9	98.8	99.4	129.0	124.3
1961-62	115.2	100.0	102.9	100.3	113.4	114.0
1962-63	114.6	96.5	102.7	96.6	104.9	103.4
1963-64	102.4	97.0	95.4	95.5	97.6	96.1
1964-65	112.6	114.0	93.95	96.82	118.8	118.31
1965-66	139.5	107.3	97.3	98.4	143.1	134.0
1966-67	110.9	96.6	103.9	101.8	123.8	123.0
1967-68	98.1	95.7	107.3	102.9	107.5	117.4

Source: C.S.O. Monthly Statistical Bulletins.

CHART II



wholesale price index are taken into consideration, this average rises to 8 per cent per annum for the entire period covered by this study.

Economists have pointed out that for an under-developed country, a rate of inflation of about 5 per cent is not very serious<sup>4</sup>. Viewed in this way, it may be said that Pakistan has enjoyed reasonable price stability in the course of her economic development. The average rate of inflation shown by different official indices also compares very favourably with several other under-developed countries during the period under study. Table 20 gives a comparison of the average rate of increase in the cost of living of selected countries. This table indicates that very high rates of inflation were experienced by the Latin American countries during the period concerned while most of the Asian countries enjoyed relative price stability. Among the Asian countries also Pakistan's performance has been relatively better. However, in order to understand Pakistan inflation more fully, the following facts must be borne in mind.

Firstly, statistics on prices and cost of living are grossly under-estimated. Difficulties of obtaining correct information from different markets and of compiling accurate statistics in a country where statistical machinery is still rudimentary are enormous. Moreover, the weights used in the compilation of various indices are often outdated and tend to present an under-estimated picture. The actual rate of inflation and the pinch of rising cost

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4. See, for example, H.G. Johnson, Essays in Monetary Economics, (London, 1967), Chapter IX P. 284 and Irving S. Friedman, "Comments on Monetary Problems of Pakistan", Journal of Political Economy, August, 1967, P. 651.

TABLE 20Average Rates of Inflation in Selected Countries

Cost of Living Indices only (Per Cent Per Annum)

Country	1954-59	1960-65	1966-68
Argentina	33.3	23.9	27.0
Australia	2.5	2.2	3.0
Bolivia	86.9	6.3	6.0
Brazil	21.9	58.0	43.0
Canada	1.6	1.6	3.7
Chile	49.8	25.2	27.2
France	4.3	3.7	3.8
Ghana	2.1	10.2	1.2
India	2.4	5.5	7.4
Iran	7.6	3.4	1.7
Japan	1.6	5.9	5.6
Korea	25.6	14.4	14.3
Mexico	7.6	2.5	3.4
Pakistan	1.8	4.2	6.3
Philippines	0.7	4.7	4.5
Turkey	14.1	4.2	10.2
U.A.R.	0.4	2.9	2.4
U.K.	2.7	3.1	4.3
U.S.A.	1.4	1.3	3.9

Source: Joseph O. Adekunle, "Rates of Inflation in Industrial, Other Developed and Less Developed Countries, 1949-65" I.M.F. Staff Papers Vol. XV 1968, Table 3 and I.M.F. International Financial Statistics, October 1969, p.31.

of living felt by the common man is often much more than what the official indices show.

Moreover, direct economic controls in Pakistan including import controls have most of the time suppressed income velocity of money. The income velocity increased sharply whenever direct controls were relaxed. If inflation had not been repressed and income velocity had been allowed a free play, price increases would have been much more pronounced than actually recorded by most of the indices examined above.

It must also be remembered that price inflation in Pakistan has been greatly diverted towards the balance of payments pressures which were pretty strong throughout the period under study in spite of import controls and attempts to accelerate exports. The current account deficits were greatly relieved by large foreign capital inflows yet foreign exchange reserves were also seriously depleted in several years under study. Internal inflationary pressures were, thus, greatly cushioned by the external sector. If pressure on the balance of payments and foreign exchange reserves is also taken into account, the over-all inflationary pressures would become all the more significant.

Lastly, a substantial part of the inflationary pressures in Pakistan have been absorbed by relative wage rigidities. As expected in a labour surplus economy, with relatively less organised labour, money wages in Pakistan have increased in the process of inflation but their rise was often much less than the rise in the cost of living so that real wages were often adversely affected. Due to this wage-lag, inflationary pressures could not fully spread themselves and the working classes had to bear the brunt of inflation.



In most modern economies, wages either serve as the initiator of inflationary pressures or at least play an active role in their transmission. This is true not only of developed countries but also of the Latin American countries where industrialization has gone far ahead of the less developed countries of Asia. In Pakistan wages have tended to absorb a part of the inflationary pressures created by large monetary flows and shortage of essential commodities including food.

All these points would be elaborated further in the study.

#### 6. A Preliminary Analysis of Price Changes:

As a prelude to the analysis proposed to be done in this study, a preliminary analysis of the observed price changes in Pakistan may be rendered here. This will, in a nutshell, give the combined effect of all the forces exerting inflationary pressure in the economy of Pakistan during the period under study. The analysis would be based on all-Pakistan data as details of some relevant variables are not available separately for each wing. Moreover, only annual changes in prices would be considered because quarterly changes in some variables required to explain these changes like national income etc. are not at present compiled in Pakistan.

As mentioned earlier, the price level in Pakistan was declining in the pre-Plan period mainly because income velocity maintained a downward trend in that period as spending opportunities were greatly limited by the existence of direct economic controls. Monetary expansion on account of deficit financing was being greatly absorbed by the rising money-income ratio. On the other hand, the foreign exchange reserves accumulated during the Korean War boom were being spent on supplementing the domestic availabilities including food supplies which were causing great concern in the face

of stagnant agricultural output and rapidly rising population. A substantial part of internal monetary expansion was thus also being absorbed by the balance of payments deficits.

In 1955-56, the G.N.P deflator showed a rise of 6.9 per cent while the P.I.D.E index of wholesale prices based on free market prices recorded a steep rise of about 25.8 per cent. This can be partly accounted for by net deficit financing of Rupees 166 million during the year and aggregate monetary expansion of Rupees 629 million. At the same time, there was a decline of about 8 per cent in food output and as imports under the P.L. 480 programme were still low and foreign exchange position was tight, food imports supplemented the domestic out-put only to a limited extent. The import prices also jumped up in that year due to the devaluation of Pakistan rupee in July 1955 and the terms of trade deteriorated by about 14 per cent. The money-income ratio, however, reached a peak of 0.198 because of high monetary expansion and limited spending opportunities on account of continued direct economic controls. Money balances, therefore, accumulated with the public which were rapidly spent in the following year. The rise in prices in this year would probably have been greater if income velocity had not substantially declined.

In the following year, net deficit financing increased further to Rupees 416 million and there was a sharp rise in bank credit to the private sector but due to the contractive effect of the external sector which showed a deficit of Rupees 217 million, the money supply increased only by Rupees 466 million. However, there was a sharp rise in income velocity and the money-income ratio declined from 0.198 in the previous year to 0.186 in this year. The

food position was, however, good in this year as the foodgrain output increased by 18.5 per cent and P.L. 480 food imports also increased significantly. But on account of a substantial monetary expansion and a sharp rise in income velocity, the price level increased very sharply. The P.I.D.E index showed a rise of 30.4 per cent and the implicit national income deflator recorded an increase of 11.1 per cent.

In 1957-58, the quantum of deficit financing further increased to Rupees 671 million but the private sector exercised a net contractive effect of Rupees 90 million on money supply due to a significant shift on the part of the public towards time deposits. At the same time, the foreign sector also exercised a net contractive effect of Rupees 282 million so that the money supply increased only by Rupees 366 million. There was also a slight decline in income velocity. But on the other hand, the foodgrain output in that year declined by 6 per cent and the P.L. 480 imports were also less than in the previous year. At the same time, other imports declined by about 11 per cent in real terms and thus general availabilities in the economy were poor in that year. The prices then recorded an increase of 5.5 per cent according to the G.N.P deflator. The P.I.D.E index, however, showed some decline because of the fact that the prices of rice and wheat used in this index declined during the year and this index has assigned heavy weight to these two commodities. The prices of raw materials and manufactures therefrom also declined significantly during the year.

In the following year, net deficit financing declined to Rupees 223.5 million as the military regime decided to curb the

deficit rate with a view to stabilize the price level. The private sector exercised a net contractive effect of Rupees 57.4 million as economic activities were greatly reduced due to tightening of economic controls and the flow of bank credit to the private sector was less than in the previous year. Moreover, there was a significant shift towards time deposits during the year which meant a leakage from the money supply. The external sector, however, exercised a net expansionary effect of Rupees 121.7 million in that year. The money supply, therefore, increased by Rupees 195 million. On the other hand, the income velocity declined sharply due to tightening of economic controls by the military regime and the money-income ratio rose to a high level of 0.197. The new regime also strongly curbed profiteering and hoarding. Although foodgrain output declined by 2.2 per cent during the year and real imports declined by about 20 per cent due to stricter import controls, general availabilities, however, increased significantly as speculative hoards were brought to the market. Due to an increase in availabilities and a decline in income velocity on account of strict economic controls, the G.N.P. deflator recorded a decline of 3.2 per cent. The P.I.D.E index however, registered a movement back to its 1956-57 level as the market prices of wheat and rice in East and West Pakistan went up due to a decline in foodgrain output.

In 1959-60, there was another sharp rise in prices when the national income deflator recorded a rise of 9.7 per cent and the P.I.D.E index rose from 115.4 to 121.8. Net deficit financing in that year was negative to the tune of Rupees 35 million but the private and foreign sectors exercised a net expansionary effect of Rupees 165 million and Rupees 220 million respectively and therefore, the money supply increased by 302 million. At the same time, income

velocity also rose very sharply as a movement towards decontrol and liberalization of the economy started in the later part of the fiscal year. The money-income ratio dropped to 0.185. General availabilities in the economy were quite good during the year as the foodgrain output increased by 13.6 per cent and the P.L. 480 food imports also increased further. The over-all rate of growth maintained by the economy was also fairly high, namely over 4 per cent. Moreover, due to relaxations in import control, imports in real terms increased by 59 per cent. Nevertheless, the rise in prices can be accounted for by the sharp rise in income velocity during the year initiated by relaxations in direct economic controls.

In the Second Plan period, there was considerable price stability on account of high rates of growth and liberalization of imports together with increased monetary and fiscal controls exercised by the authorities. In 1960-61, net deficit financing amounted to Rupees 108 million and the private sector also exercised a net expansionary effect of Rupees 135 million on the money supply but the foreign sector absorbed a large part of the internal monetary expansion so that net increase in money supply was only Rupees 29 million. But with the liberalization of imports and other economic controls, income velocity increased further and the money-income ratio declined sharply to 0.168. General availabilities in the economy were very good because of liberalized imports, expanded P.L. 480 programme and a rise of 7 per cent in foodgrain output. However, because of a sharp rise in income velocity, the price level went up by 5 per cent as shown by the G.N.P deflator. The C.S.O index of wholesale prices, however, showed a rise of only 3 per cent as the price of rice in East Pakistan declined significantly during the year due to a good crop and it has a substantial weight in the index.

The following year, net deficit financing totalled Rupees 290 million and the private sector also exercised a net expansionary effect of Rupees 411 million on the money supply. But due to a large contractive effect of the external sector, the money supply increased by Rupees 226 million. Income velocity also increased to some extent in that year as the money-income ratio declined from 0.168 to 0.166. But, on the other hand, the rate of economic growth was high during the year, namely 6 per cent. The food output also went up by 1.9 per cent and imports in real terms were also higher than in the previous year and, therefore, general availabilities in the economy were very good. The G.N.P deflator, therefore, showed a decline of 0.9 per cent in that year. The C.S.O index of wholesale prices however, moved in a different direction and showed a rise of 2.8 per cent due to the fact that wholesale prices of rice, fish and cotton manufactures in East Pakistan recorded a significant rise as the supply position was not good in that province and East Pakistan has a heavy weight in the wholesale price index. The cost of living also, therefore, showed a rise in that province.

In 1962-63, the G.N.P deflator recorded a rise of 1.9 per cent but the C.S.O wholesale price index showed a decline of 1 per cent. The disparity between the two indices is quite understandable as the national income deflator is a broad-based index and includes the prices of all goods and services comprising the national income whereas the wholesale price index includes only the change in wholesale prices of major commodities in different markets. As the prices of jute and jute manufactures, cotton and cotton manufactures and wheat registered a decline in both provinces, the wholesale price

index was markedly influenced by them. Monetary expansion in that year was fairly high namely Rupees 846 million which was jointly contributed by the Government, the private and the foreign sectors to the extent of Rupees 165, Rupees 364 and Rupees 274 million respectively. But income velocity in that year declined as money balances were not quickly spent by the public and the money-income ratio increased to 0.179. The foodgrain output during the year declined by 3.7 per cent but it was very heavily supplemented by imports under the P.L. 480 programme and imported wheat was released by the Government at reduced prices in both wings of the country. Other imports in real terms also increased by 16 per cent. Thus monetary expansion was partly absorbed by an increase in the demand for money and partly by good supplies in the economy and, therefore, the pressure on prices was not much.

In the following year, monetary expansion was one of the highest especially as net deficit financing increased sharply to Rupees 627 million and the contribution of private sector to monetary expansion also turned out to be high, namely Rupees 418 million. Deficit financing was high in that year because Government's capital expenditures rose sharply in an attempt to achieve the Plan targets well in time. On the other hand, with import liberalization, economic activities in the private sector were already increasing. Internal monetary expansion was, however, partly absorbed by the contractive effect of the foreign sector of about Rupees 153 million. The money supply, therefore, increased by Rupees 1029 million. But it was heavily absorbed by a sharp rise in money-income ratio to 0.192 and also a high rate of economic growth of 8.3 per cent. The foodgrain output also went up by 12.4 per cent and it was heavily supplemented by P.L. 480 food imports. Other imports in real terms also increased

by 23 per cent in that year. For all these reasons, the G.N.P deflator registered a decline of 1 per cent during the year. The C.S.O wholesale price index, however, recorded only a nominal decline of 0.2 per cent.

In 1964-65, net deficit financing was reduced to Rupees 359 million but there was a sharp rise in private sector's contribution to money supply namely of Rupees 920 million. Internal monetary expansion was, however, partly absorbed by the contractive effect of the foreign sector of Rupees 357 million. The money supply, therefore, increased by Rupees 682 million. This was also coupled with a rise in income velocity as the money balances accumulated in the previous year were rapidly spent in that year and the money-income ratio declined to 0.189. Although the economy maintained a rate of growth of 4.5 per cent and the foodgrain output also increased by 2.5 per cent, the pressure on food prices was quite significant in both wings. Prices of cotton, jute and jute manufactures also increased significantly during the year. The wholesale price index then recorded a rise of 7.4 per cent and the G.N.P deflator a rise of 4 per cent.

In the following year, net deficit financing was the highest namely Rupees 1680 million on account of a sharp rise in defence expenditure due to Pakistan's war with India. But the private sector exercised a net contractive effect of Rupees 445 million as time deposits increased significantly due to limited spending opportunities in the economy as a consequence of the tightening of economic controls. For the same reason, the money-income ratio also reached a peak of 0.198. Although, money supply in that year increased by Rupees 1221 million, it was greatly



absorbed by the rise in money-income ratio. The over-all rate of growth in the economy was 4.6 per cent but the foodgrain output declined by 3.3 per cent due to unfavourable weather conditions. On the other hand, P.L. 480 imports were also greatly reduced on account of cut-backs in foreign aid. Other imports into the economy were also seriously curtailed due to foreign exchange difficulties. The G.N.P deflator then recorded a rise of 4.5 per cent and the wholesale price index a rise of 4.6 per cent. Wheat prices, however, remained low because of a bumper crop in 1964-65.

In 1966-67, the price rise was one of the highest recorded during the period under study. The wholesale price index jumped from 117.5 in 1965-66 to 133.9 in that year showing a rise of about 14 per cent. The national income deflator also recorded a rise of 12.1 per cent. The sharp rise in prices was to a considerable extent due to a rapid increase in income velocity as the public spent their money balances rapidly after relaxations in direct economic controls and the money-income ratio declined from 0.198 to 0.178. Net deficit financing was negative in this year to the tune of Rupees 7.9 million but private borrowings from the banking system increased sharply as economic activities recovered from the depressing effect of Pakistan's war with India. The private sector exercised a net expansionary effect of Rupees 835 million but the external sector absorbed a part of the internal monetary expansion by registering a deficit of Rupees 493 million. The aggregate money supply, therefore, increased by Rupees 541 million. The monetary factors responsible for inflationary pressures were coupled with the deterioration in food position in both parts of the country due to drought and floods. Foodgrain output declined by 4.3 per cent and the P.L. 480 food imports continued to

be low. Food prices, therefore, jumped up very sharply. Although the economy maintained an over-all growth of 5 per cent and real imports increased by 32 per cent with a revival towards economic liberalization, the poor food supplies together with large monetary flows caused a severe pressure on prices during the year.

In the following year, the government and foreign sectors exercised net expansionary effects of Rupees 685 million and Rupees 173 million respectively on the money supply but the private sector exercised a net contractive effect of Rupees 83 million as there was a large shift towards time deposits during the year. The money supply, therefore, increased by Rupees 375 million. This was also coupled with some increase in income velocity as the money-income ratio further declined to 0.174. But the over-all growth in the economy was one of the highest recorded during the period under study, namely 7.5 per cent and the foodgrain output increased by 22 per cent due to exceptionally good crops. The P.L. 480 food imports also revived to their former level with a revival of foreign economic aid to Pakistan. Aggregate imports in real terms were also high as import controls had already been liberalized in the previous year. For all these reasons, general availabilities in the economy were exceptionally good. The wholesale price index therefore recorded a decline of 4 per cent and the G.N.P deflator a decline of 1.5 per cent despite the fact that the monetary factors exercised a significant expansionary effect.

### CHAPTER III

#### WAGE MOVEMENTS, INCOME DISTRIBUTION AND INVESTMENT PATTERN

An inflationary economy is bound to exhibit certain distortions and repercussions. Normally, inflation adversely affects the distribution of income, the pattern of investment and the balance of payments position of the country concerned. Inflation generally turns the distribution of income in favour of capitalists, entrepreneurs and others who benefit by rising prices. On the other hand, wage-earners and fixed income groups suffer from inflation. Wages often tend to lag behind the rising prices and this is more likely to be the case in a labour surplus economy. Rising prices and profits coupled with wage-lags and other income rigidities create serious distortions in the distribution of national income. The pattern of investment and resource allocation is also adversely affected by the inflationary rise in prices. While aggregate investment ( including fixed investment and stock formation ) tends to rise with rising prices, the tendency to hedge against inflation begins to gain ground and the investment pattern tends to be biased towards less productive forms like the acquisition of real assets. Investment in real estate and stock-piling is often encouraged in the process of inflation and the stronger the inflationary pressures, the greater will be this tendency. Lastly, inflation affects the balance of payments position of the country by discouraging<sup>exports and encouraging</sup> imports provided the rest of the world is experiencing no inflation or less inflation. The balance of payments problems of Pakistan will be examined in a later

chapter while the effects of inflation on the distribution of income and resource allocation are discussed in the present chapter.

#### 1. Wage Movements And Income Distribution:

When prices are rising, the working classes try to maintain their share in the real national income by demanding higher wages with every price increase. To what extent they are able to maintain their share in the real national income depends upon the pace of wage increases viz-a-viz price increases and this in turn depends upon the bargaining power of labour as a class. In a labour surplus economy, with considerable unemployment, the bargaining power of labour is greatly weakened. Labour is also often less organised in these countries because of the lack of industrial traditions and education among the working classes. Nevertheless, some rise in wages does take place in the process of inflation though the wage-lag is often well marked. Wages in Pakistan increased in the process of inflation but they could not keep pace with the rising prices. Complete wage statistics are not available for all years and all sectors of the economy as this is the most neglected aspect of the statistical information compiled in Pakistan. However, the available data on money and real wage rates in the manufacturing sector of Pakistan are given in Table 21. Chart III presents this information graphically. It is evident from this table that money wages in the manufacturing sector remained almost static during the period 1956-59 though prices were rising at a fast rate so that real wages declined

significantly in this period. There was a noticeable increase in money wages after 1959 and they increased substantially during the period 1963-66. The real wages, however, maintained a declining trend until about 1962 as the rise in money wages lagged behind the rise in cost of living. But during the period 1963-66, the real wages also increased to some extent. On the whole, the rise in wages has lagged behind the rise in prices and the growth of gross national product. Due to this wage-lag in Pakistan, the real wages remained stuck up at what may be called the bare subsistence level and living standards of the working classes did not show any significant improvement.

The obvious explanation of this wage-lag in Pakistan and probably in some other Asian countries also, is the presence of an excess supply of unskilled labour and the consequent competition between them due to which the employers need not bid for them by offering higher wages. The high rate of population growth and of labour force with comparatively little industrialization in Pakistan has resulted in serious unemployment and under-employment and this has greatly affected the level of wages and their rate of increase in the process of economic development. This does not mean that industrialization and economic development have not resulted in a rise in the demand for labour but the fact is that while the rising demand for labour slightly reduced unemployment, the real wage remained almost unchanged. As shown earlier, money wages in Pakistan increased in the process of development and inflation but most of the time their rate of increase lagged behind the rate of increase in prices and cost of living so that the real wage either declined or increased very

slowly. It is generally thought that at least for some time to come the real wage of unskilled workers in Pakistan is not likely to rise much though their productivity would rise with capital accumulation and technical progress, due to the excess supply of labour and high unemployment. The per capita incomes have also risen with a rise in the G.N.P but the rate of increase in real wage has lagged behind the rise of per capita income also. The standard of living of the working classes has, therefore, not changed much despite economic development. This seems to be true not only for Pakistan but for the South Asian region as a whole<sup>1</sup>.

Wages in Pakistan are generally fixed through collective bargaining and they differ from one industry and occupation to another. The wage rates given in Table 21 are annual averages of various manufacturing industries in Pakistan. By and large, the bargaining position of workers in most industries is very weak and they are also not properly organised. In order to protect the interest of those workers who are in an unusually weak position or do not have an organised trade union, a minimum wages ordinance was promulgated by the Central Government in 1961. Under this, the Government regulates wages in those industries where it feels that they are inadequate. This is done through a wage board which includes representatives of the Government, the employers and workers. However, in most cases wages are fixed through direct negotiations between the workers' unions and the employers. But

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1. Cf. A.D. Smith ( Ed. ), Wage Policy Issues in Economic Development (Macmillan and Co., London, 1969) Part A Section III and the I.L.O., General Report to the Asian Advisory Committee, ( Singapore, December, 1966) PP 58-59.

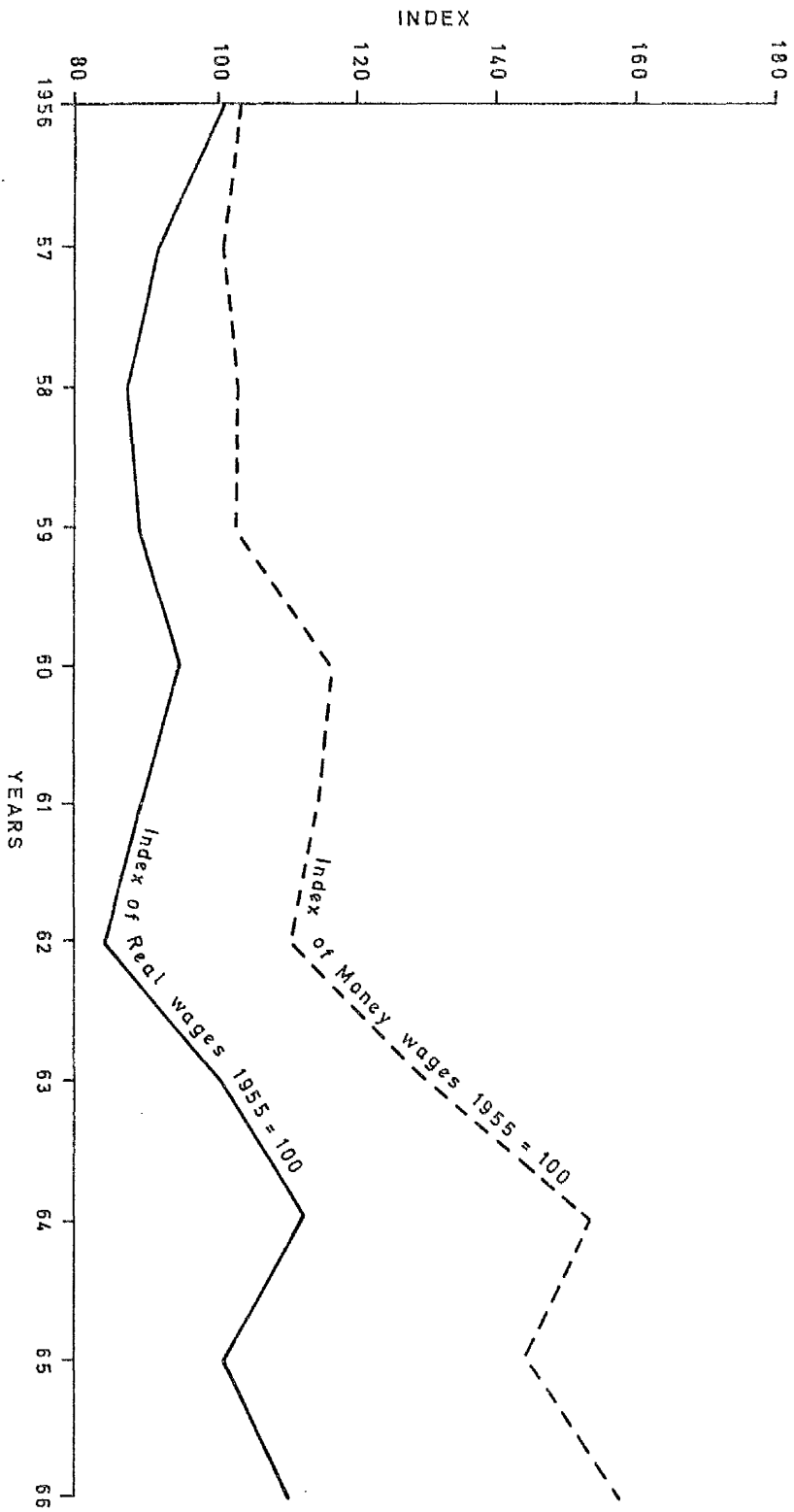
TABLE 21Movement of Money and Real Wages in the ManufacturingSector of Pakistan

Year	Average Money Wages in Manufacturing Sector (Annual)	Index 1955=100	Average Real Wages in Manufacturing Sector+ (Annual)	Index 1955=100
1956	996	103.6	1023	100.9
1957	977	101.7	931	91.9
1958	995	103.5	881	86.9
1959	991	103.1	901	88.9
1960	1119	116.4	956	94.3
1961	1098	114.2	900	88.8
1962	1061	110.4	849	83.8
1963	1262	131.3	1018	100.5
1964	1483	154.3	1149	113.4
1965	1392	144.8	1031	101.7
1966	1524	158.5	1120	110.5
1967	N.A.	N.A.	N.A.	N.A.
1968	N.A.	N.A.	N.A.	N.A.

+ Deflated by the Cost of Living Index.

Source: Computed from the I.L.O., Yearbooks of Labour Statistics.

CHART III



INDEXES OF MONEY AND REAL WAGES IN MANUFACTURING SECTOR OF PAKISTAN



on the whole the trade union movement in Pakistan is still very weak. Most of the unions are organised within individual establishments and their development on the basis of craft or of industry is not yet a common feature. Taken all round, the role of collective bargaining in South Asia seems to be still very limited<sup>2</sup>.

In two studies on wages in Pakistan, A.R.Khan found that although the money wage rates increased over the decade 1954-64 both in East and West Pakistan, the real wages declined in that period. He also found that there is not much difference between the average wage in the industrial and agricultural sectors. Competition in the labour market has tended to narrow the gap between wages in the two sectors to a level necessary to compensate for urban-rural differences in cost of living and rudimentary training provided to unskilled and semi-skilled workers in the industrial sector.<sup>3</sup>

Working on the data contained in the C.S.O Censuses of Manufacturing Industries<sup>4</sup>, A.R.Khan, found that during the period 1954-55, real wages in East Pakistan, for industry as a whole, remained lower in all years as compared with the base year (1954). The real wage declined sharply in 1955 and then remained fairly stable until 1962-63 when the recovery was more pronounced. For textiles in East Pakistan, there was a small rise in 1955 over the

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2. Cf. A.D. Smith, Op.Cit. P. 25

3. Cf. A.R.Khan, "What Has Been Happening to Real Wages in Pakistan" Pakistan Development Review, Vol.VII No.3, Autumn, 1967 and also Wages and Prices in Karachi: A Case Study, (P.I.D.E Monograph No.8, Karachi, 1961).

4. These are not annual and are available only for some years.

base year and then a fairly sharp decline in 1957. Recovery started from 1958 and continued up to 1962-63 when the base year value was slightly exceeded. An upward bias in East Pakistan textile wages is created throughout the period due to continuous rise in the share of jute textiles ( wages in jute textiles being on the average about 20 per cent higher than wages in cotton textiles ). When real wage rates for jute and cotton textiles are estimated separately, real wages in each of them were still lower by 1962-63 as compared with the base year.

In West Pakistan, the result is more striking. The real wage rate for aggregate industries dropped in 1955 over the base year level and remained fairly stable until 1962-63 when it dropped sharply again. In textiles also, there was a fairly sharp decline up to 1957 after which it remained stable for about half a decade. It again declined by a few percentage points in 1962-63. Thus real wages at the aggregate level have, on the average, been about 25 per cent higher in West than in East Pakistan. This does not include any adjustment for the regional difference in purchasing power. When adjusted for the difference in purchasing power of wages in the two regions, the disparity would be greater. A study made by Abdul Ghafur on interregional purchasing power of wages indicates that the prices of wage-goods on the average were about 10 to 15 per cent higher in East Pakistan in the years 1961 and 1965-66 for which he has undertaken the study<sup>5</sup>.

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5. Cf. Abdul Ghafur, "A Comparison of the Interregional Purchasing Power of Industrial Wages in Pakistan", Pakistan Development Review, Winter 1967.

TABLE 22

REAL WAGES ( WAGES DEFLATED BY 1954 BASED COST OF LIVING INDEX ), BASED ON  
CMI DATA ( RUPEES PER YEAR PER WORKER )

YEAR	EAST PAKISTAN				WEST PAKISTAN			
	ALL INDUSTRIES		TEXTILES		ALL INDUSTRIES		TEXTILES	
	Real Wage	Index	Real wage	Index	Real Wage	Index	Real Wage	Index
1954	794.5	100.0	759.4	100.0	966.2	100.0	963.7	100.0
1955	702.3	88.4	783.8	103.2	911.5	94.3	960.5	99.7
1957	726.5	91.4	644.4	84.9	909.4	94.1	892.7	92.6
1958	743.3	93.6	672.4	88.5	933.6	96.6	887.3	92.1
1959-60	737.5	92.8	718.3	94.6	936.7	96.9	894.4	92.8
1962-63	766.2	96.4	773.0	101.8	854.4	88.4	859.4	89.2
1963-64	--	--	--	--	870.6	90.1	--	--

Source: A.R.Khan, "What Has Been Happening to Real Wages in Pakistan",  
Pakistan Development Review, Autumn, 1967, Table 1.

TABLE 23RATIO OF WEST PAKISTAN'S REAL WAGE TO EAST PAKISTAN'S  
REAL WAGE ( BASED ON CMI DATA )

YEAR	ALL INDUSTRIES	COTTON TEXTILES
1954	1.22	1.38
1955	1.30	1.46
1957	1.25	1.46
1958	1.26	1.47
1959-60	1.27	1.48
1962-63	1.17	1.42

Source: A.R.Khan, Op.Cit, Table V

To overcome the possible distortion due to the difference in regional composition of industries, one could refer to the regional disparity in cotton textile workers' wages. This is considerably greater than the disparity for the aggregate manufacturing sector ( about 45 per cent higher in West Pakistan than in the East on an average ). Table 22 presents the real wages in East and West Pakistan based on the Censuses of Manufacturing Industries data. Table 23 presents the ratio of West Pakistan's real wage to East Pakistan's real wage.

It is obvious that any rise in money wages during the period under study would have been passed on to the consumers in the form of higher prices but there is no evidence in Pakistan of a wage-price spiral as such. On the contrary, wages have risen rather reluctantly during the period under study and the burden of inflation has been greatly borne by the working classes. Wages are often an important transmitter and in some economies the initiator of inflation but in the case of Pakistan, because of high unemployment and abundant supply of labour, the rate of inflation has been greatly curbed by the slow rise in wages and absence of a wage-price spiral.

On the other hand, inflation has promised high profits to entrepreneurs. There has been a fairly wide gap between the input and output prices of manufactured goods as wages and raw material prices have risen at a slower rate than the prices of manufactured goods. Liberal tax concessions, high protective tariffs, over-valued currency and low-priced labour have all ensured high profits to the manufacturers in Pakistan. In the early years of industrialization profits were especially high because of limited competition. As

competition grew in the manufacturing sector, profit margins somewhat declined, yet remained on the higher side. According to the Censuses of Manufacturing Industries, gross profits ( value added minus employment costs ) as a per cent of sales ( value of products made ) were as high as 23 per cent in 1954 but they dropped to 20 per cent in 1957. Gross profits in cotton textiles declined more sharply from 35 per cent to 24 per cent in the same period<sup>6</sup>. From a study of public limited companies quoted on Karachi Stock Exchange, K. Haq and M. Baqai have reported that gross profits as a ratio of gross sales declined from 19.7 per cent to 18.2 per cent during the period 1959 and 1963. The ratio of gross profits to gross capital employed also declined from 14.2 per cent in 1959 to 13.4 per cent in the same period. With the liberalization of economic controls, particularly in respect of the import of capital goods and raw materials and introduction of a greater degree of competition in the economy coupled with restraint on monetary expansion, the profit margins registered a decline<sup>7</sup>. Table 24 gives the available information on the amount and distribution of industrial profits in Pakistan during the period 1958-63.

In spite of a decline in the rate of industrial profits, the rate of industrial investment in 1964-65 was more than double that of 1959-60<sup>8</sup>. It is also evident from Table 24 that industrial companies in Pakistan were saving an increasing proportion of their profits in the 1960's. All this tends to show that industrial investments in Pakistan were still very profitable and economic incentives were pretty strong.

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6. Cf. Central Statistical Office, Censuses of Manufacturing Industries, (1954, 1955 and 1957).

7. Cf. K. Haq and M. Baqai, "Savings and Financial Flows in the Corporate Sector, 1959-63", Pakistan Development Review, Autumn, 1967.

8. Cf. G.F. Papanek, Pakistan's Development (Harvard University Press, 1967), P. 13, Table 3.

TABLE 24

## Amount and Distribution of Industrial Profits (Million Rs.)

	1958	1959	1960	1961	1962	1963
Gross Profits Before Taxes	585	261.6	332.2	367.8	422.2	521.6
Profit Taxes	168	77.6	101.2	95.6	110.8	158.4
Depreciation	163	82.9	86.0	112.2	124.2	143.5
Dividends	123	53.7	71.5	75.8	83.5	94.0
Retained Earnings	131	47.4	74.5	84.2	103.9	125.7
Industrial Assets	4772.7	2189.4	2605.5	3224.6	3719.7	4674.7
Gross Saving	294	130.3	160.5	196.4	228.1	269.2
Gross Profits After Taxes	417	184.0	232.0	272.2	311.6	363.2
Gross Saving ÷ Industrial Assets	6.2%	6.0%	6.2%	6.1%	6.1%	5.8%
No. of Companies Included	All in Papanek Survey	59	70	86	91	104
Gross Saving ÷ Gross Profits	70.5%	70.8%	69.2%	72.2%	73.2%	74.2%

Source: Stephen R. Lewis: Pakistan: Industrialization and Trade Policies, (Oxford University Press, 1970) p.54.

Reluctantly rising wage rates in the industrial sector of Pakistan and relatively high profits have greatly distorted the distribution of income in Pakistan in favour of capitalists and entrepreneurs. On the other hand, the working classes have been forced to bear the brunt of inflation and the rising cost of living in the economy. The process of economic development in Pakistan has resulted in acute concentration of wealth in a few hands and inflation has made the rich richer and the poor poorer. There is a growing discontent in the country about increasing concentration of income and wealth and economic power in the hands of a relatively few. A few family groups own industrial undertakings, banks, insurance companies, distribution trade etc. and exercise tremendous economic power. According to the Third Five Year Plan document, the top 5 per cent in Karachi have incomes 27 times higher than the bottom 5 per cent<sup>9</sup>.

In addition to the distortions in income distribution in urban industrial sector, there has been considerable redistribution of income from the rural to the urban sector in the course of economic development and inflation. Domestic resources have been mobilized in Pakistan by restraining the growth of living standards of the poorest members of the society namely the rural masses. There was a considerable transfer of savings from the agricultural to the industrial sector as terms of trade were deliberately turned against agriculture in the 1950's through such policies as licensing of scarce foreign exchange earned primarily by agriculture to the industrial sector, compulsory government procurement of foodgrains

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9. Government of Pakistan, Planning Commission, The Third Five Year Plan, 1965-70, May, 1965, P. 29.



at low prices to subsidize the cost of living of the urban industrial workers, generous tax concessions to industry and lack of similar incentives for commercial agricultural investment. Government's measures had the effect of reducing per capita income and consumption in rural areas in relation to the rate of growth of per capita gross national product. Table 25 presents a comparison of the growth of per capita gross national income and per capita rural incomes during the decade 1954-55 to 1964-65. This table clearly shows that while the gross national income per capita was rising over the period, the per capita rural incomes remained more or less unchanged. According to an estimate by K.B. Griffin the average urban incomes in Pakistan are six times higher than rural incomes ( Rupees 1278 against Rupees 207 ) and that they grew four times faster ( 12.8 per cent over the period 1954-55 to 1964-65 against 3 per cent ).<sup>10</sup> Thus the fruits of development have been reaped by the minority of urban rich while the majority of population in rural areas still remain very poor. Even in urban areas, the bottom 5 per cent are probably as poor as their equivalent in the rural group.

## 2. Investment Pattern And Resource Allocation:

Development efforts in Pakistan have obviously led to a substantial increase in public and private sector investment. Tables S.A. 1 to S.A. 6 in the Statistical Appendix show the aggregate development expenditures in the three plans and their sectoral break-up. It is evident from these tables that development outlays increased very sharply from one Plan to another and these led to a rapid increase in Government's borrowing from the banking system,

10. Cf. K.B. Griffin, "Financing Development Plans in Pakistan", Pakistan Development Review, Winter, 1965.

TABLE 25GROWTH OF G.N.P PER CAPITA AND PER CAPITA RURAL INCOME

YEAR	G.N.P Per Capita ( Rupees )	Rural Income Per Capita ( Rupees )
1954-55	316	201
1955-56	316	199
1956-57	316	199
1957-58	317	195
1958-59	317	195
1959-60	318	194
1960-61	326	197
1961-62	334	199
1962-63	342	202
1963-64	351	205
1964-65	360	207

Source: K.B. Griffin, "Financing Development Plans in Pakistan",  
Pakistan Development Review, Winter, 1965, Table III.

monetary expansion and money income. In the private sector also, bank borrowings were the major source of development funds and these created inflationary pressures in the economy. However, evidence does not suggest that <sup>m</sup>inflation has encouraged real savings and real investment in Pakistan to any significant degree. The structuralists claim that inflation encourages domestic savings through its redistributive effects and that investment is also encouraged as investment opportunities become more profitable in the course of inflation. Table 26 gives relevant data on domestic savings and capital formation for Pakistan. This table indicates that although real savings and real capital formation increased substantially over the period under study, changes in them do not seem to be much related to price changes. On the other hand, both savings and capital formation bear a close relationship to the availability of capital goods, raw materials and Government's import policy. Whenever the supplies of capital goods and other materials were adequate, real investment tended to rise sharply and vice versa. Real savings were also greatly determined by investment opportunities in the economy. In the absence of proper investment opportunities, potential savings tended to divert towards redundant consumption and other socially unproductive activities.

In the First Plan period, prices were rising at a fast rate but foreign exchange was extremely scarce and there was an acute shortage of capital equipment and raw materials and, therefore, real investment and savings were rather low and did not rise much. On the other hand, in the Second Plan period, there was considerable price stability but due to the expanded foreign aid, programmes and resulting import liberalization, supply of capital goods and raw materials had greatly improved and, therefore, both real savings and real investment responded very favourably. In the Third Plan period

TABLE 26REAL CAPITAL FORMATION AND REAL SAVINGS

YEAR	<u>CAPITAL FORMATION</u>		<u>DOMESTIC SAVINGS</u>	
	Current Prices	1954-55 Prices*	Current Prices	1954-55 Prices*
1955-56	1670	1562	1440	1347
1956-57	1850	1557	1015	854
1957-58	2210	1762	1175	937
1958-59	2370	1952	1500	1235
1959-60	3840	2909	2875	2178
1960-61	4605	3322	3225	2327
1961-62	5710	4159	4205	3063
1962-63	6710	4796	4885	3492
1963-64	7625	5501	5130	3701
1964-65	9100	6267	6085	4190
1965-66	6964	4588	4714	3105
1966-67	8629	5067	5245	3079
1967-68	10845	6471	6552	3909

\* Deflated by the G.N.P deflator.

Source: Computed from Government of Pakistan, Planning Commission Data.

again both real capital formation and real savings declined sharply as foreign exchange difficulties and import restrictions limited the investment opportunities.

Savings were adversely affected by sharply rising prices in certain years under study through the inflation tax reaction of the public. Profit margins also play an important role in determining the level of investment and of savings. Detailed information on profits in Pakistan is not available, nevertheless, the information given in Table 24 suggests that gross profits in the corporate sector have been determined mostly by the degree of competition rather than by price changes. Profits increased in some periods of falling prices and decreased in some periods of rising prices. By and large profit margins were high in the early years of industrialization when competition was less and declined as competition grew irrespective of the movements of general price level. Studies also indicate that non-corporate private savings in Pakistan have not risen much since 1949.<sup>11</sup> Furthermore, a sample survey in Dacca revealed that as much as 42.5 per cent of personal savings in the urban sector are in the form of gold ornaments, consumer durables and housing<sup>12</sup>. In periods of rising prices especially, savings either reduce or tend to divert towards unproductive investment and hoards.

It is also generally believed and more particularly by the monetarists that inflation tends to distort the pattern of investment since investment in stocks and real estate often increases as the public try to hedge against inflation. Table 27 presents the

11. Cf. Stephen R. Lewis and M.I.Khan, "Estimates of Non-corporate Private Saving in Pakistan: 1949-1962", Pakistan Development Review, Spring 1964.

12. Cf. M. Habibullah, Pattern of Urban Savings; A Case Study of Dacca City, (Dacca University, 1964).

investment in stock formation and its ratio to gross national product together with the contribution of construction to gross national product at factor cost during the period under study. While stock formation shows no specific trend over the period concerned, the contribution of construction to G.N.P increased substantially. Construction activity has particularly gained momentum in Pakistan because under conditions of inflation and economic uncertainties, the public have considered investment in housing as the safest type of investment. Speculation in land and real estate has increased substantially over the period under study as the public have tried to hedge against the rising prices.

On the whole, conditions in Pakistan do not suggest that inflation has assisted economic growth because it has not pushed up real savings and investment to any significant degree. On the contrary, steady rates of growth in Pakistan in some periods, especially in the Second Plan period, have coincided with relative price stability. All this weakens the argument that inflation may be effectively used as an stimulant to economic growth in Pakistan. Relative price stability should, therefore, be the desideratum of Government's development policy. Economic policies must be directed to maintain reasonable price stability in the economy both in the interest of steady economic growth and distributional justice. Nevertheless, a margin of a few per cent increase in prices every year and perhaps more in years of poor crops cannot be ruled out.

TABLE 27Investment in Stock Formation and Construction

Year	Stock Formation (Million Rupees)	Ratio to G.N.P. in %	Contribution of Construction to G.N.P. in %
1955-56	190	0.8	1.8
1956-57	150	0.6	1.9
1957-58	70	0.3	2.0
1958-59	90	0.3	2.0
1959-60	800	2.5	2.1
1960-61	275	0.8	2.4
1961-62	345	0.9	2.8
1962-63	380	0.9	3.0
1963-64	240	0.6	4.3
1964-65	920	2.0	4.7
1965-66	-710	-1.4	4.3
1966-67	180	0.3	4.5
1967-68	1500	2.4	4.5

Source: Computed from C.S.O., Monthly Statistical Bulletins.

## CHAPTER IV

### THE MONETARY FACTORS LEADING TO INFLATION

We now turn to sort out the factors exerting pressure on prices and balance of payments in Pakistan during the period under study. To begin with, we examine the monetary factors leading to the over-all inflationary pressures in the economy. In the present chapter, we analyze monetary expansion and the demand for money while a critical appraisal of monetary and fiscal policies will be done in the following chapter.

Considered as a means of payment, the money supply in Pakistan consists of currency and coins circulating in the hands of the public outside the banks and demand liabilities of the banking system. The latter include the demand deposits of the public with scheduled banks<sup>1</sup> and certain other deposits with the State Bank of Pakistan excluding counterpart funds, the I.B.R.D Indus account and the I.M.F account no: 1. Counterpart funds represent the sale proceeds of commodities received under the U.S.P.L. 480 programme. This fund is not included in the money supply but it has a great bearing on the latter. Releases are made from this fund to the Government of Pakistan by the representatives of the donor country for financing agreed development projects. An excess of releases from this fund over accumulations in a given year exercises a net expansionary effect on the money supply and is more or less equivalent in its net effects to deficit financing. On the other hand, an excess of accumulation over releases exercises a net contractive effect on the money supply. It is, therefore, a practice in Pakistan to adjust monetary expansion

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1. A scheduled bank in Pakistan is a commercial bank whose capital assets exceed half a million of rupees and which has been placed on the 'schedule' maintained by the State Bank of Pakistan.



on Government account for changes in counterpart funds. The I.M.F account no. 1, on the other hand, represents the rupee counterpart of the Government of Pakistan's equity claim in the Fund and is not a working balance for the Fund's expenditure in Pakistan. Consequently, it is not included in the money supply.

The money supply in Pakistan exhibits significant seasonal variations due to the fact that, in a primarily agricultural economy, the demand for bank credit increases during the period September to March for financing the movement of major crops and gets slack in the rest of the year. In this study, however, only the annual changes in money supply caused by variations in the internal and external assets of the banking system will be considered. The reason for choosing annual variations is that quarterly variations of certain other variables in relation to which the changes in money supply are to be considered are not available.

The money supply increased steadily and more than doubled during the period under study. While demand deposits were more than three times in 1967-68 as compared with 1955-56, currency in circulation increased at a slower rate and was less than twice that of 1955-56. The proportion of currency in total money supply, therefore, declined and the monetary expansion was largely due to the rapid increases in demand deposits. With the increasing tempo of economic development in the country, the claims of the banking system on the Government and private sectors increased at a fast rate and this resulted in a significant increase in demand deposits. The rate of monetary expansion during the period under study far exceeded the rate of growth in real income and since monetary expansion could not

be fully absorbed by the demand for money and available imports, it reflected in the rising prices. The average annual rate of growth in the money supply during the period was about 13.8 per cent while the average rate of economic growth was only about 5.5 per cent per annum.

Monetary growth during the period was determined by three factors: (a) the Government's deficit financing operations, (b) the flow of bank credit to the private sector and (c) changes in the external assets and liabilities of the banking system. The sources of monetary expansion are considered below in detail. The growth of money supply during the period under study is shown in Table 28 while Tables 29, 30 and 31 give its causative analysis.

#### 1. Government's Deficit Financing Operations:

The term deficit financing normally refers to the government's over-all budget deficit which may be financed by printing new currency, borrowing from the banking system and the general public, utilization of government's cash balances or some combination of these. In the case of Pakistan, the over-all budget deficit cannot be taken to mean deficit financing because of the fact that considerable part of this deficit is financed by foreign aid and loans which provide real resources to the country and do not merely mean an increase in money supply. Likewise internal borrowings from the general public and non-banking institutions do not lead to direct creation of money and only transfer funds from private hands to the Government. In an under-developed country, it is the objective of Government's economic policy to tap all available resources for financing economic development and therefore such

TABLE 28Growth of Money Supply in Pakistan, 1955-68 (Million Rupees).

Last Friday of June	Currency in Circulation	Demand Liabilities	Other Deposits with State Bank of Pakistan	Money Supply
1955-56	2,981.6	1,431.2	72.6	4,485.4
1956-57	3,372.8	1,490.1	88.3	4,951.2
1957-58	3,581.7	1,689.2	46.0	5,316.9
1958-59	3,597.9	1,869.6	43.9	5,511.4
1959-60	3,772.1	1,997.1	43.7	5,812.9
1960-61	3,806.2	1,990.7	45.1	5,842.0
1961-62	3,824.9	2,190.1	49.5	6,064.5
1962-63	4,081.5	2,779.8	49.6	6,910.9
1963-64	4,612.1	3,274.0	53.6	7,939.7
1964-65	4,902.1	3,655.1	64.2	8,621.4
1965-66	5,802.0	3,949.4	91.5	9,842.9
1966-67	5,561.7	4,689.6	132.3	10,383.6
1967-68	5,783.0	4,899.0	76.0	10,758.0

Source: State Bank of Pakistan, Currency and Finance Reports and  
Monthly Bulletins.

Causative Analysis of Changes in Money Supply (First Plan) (Million Rupees)

Causative Factors July-June basis	1955-56	1956-57	1957-58	1958-59	1959-60
Changes in Money Supply	+629.4	+465.8	+365.7	+194.5	+301.5
Domestic Private Sector	+ 99.5	+237.0	+ 41.5	- 4.2	+357.5
Adjustment for shift to Time Deposits	- 44.4	- 4.8	-131.6	- 53.2	-192.6
Net Private Sector	+ 55.1	+232.2	- 90.1	- 57.4	+164.9
Govt. Sector	+321.5 <sup>(1)</sup>	+862.1	+706.5	+250.3	+123.0 <sup>(4)</sup>
Adjustment for Counterpart Funds	-155.2	-446.1	- 35.8	- 26.8	-157.9
Net Govt. Sector	+166.3	+416.0	+670.7	+223.5	- 34.9
Foreign Sector	+444.5 <sup>(2)</sup>	-217.1	-282.3	+121.7 <sup>(3)</sup>	+220.2
Other Factors	- 36.5	+ 34.7	+ 67.4	- 93.3	- 48.7
Total Causative Factors	+629.4	+465.8	+365.7	+194.5	+301.5

(1) Adjusted for cancellation of ad hocs against devaluation profit. (2) Adjusted for devaluation profit. (3) Adjustment for revaluation of gold. (4) Adjusted for gold payments of \$12.5 million to the I.M.F. consequent upon 50% increase in Pakistan's Fund quota. The Govt. borrowed money for this purpose from the State Bank of Pakistan by creating fresh ad hocs.

TABLE 50

## Causative Analysis of Changes in Money Supply (Second Plan) (Million Rupees)

Causative Factors July-June Basis	1960-61	1961-62	1962-63	1963-64	1964-65
Changes in Money Supply	+ 29.1	+225.5	+846.4	+1028.8	+681.7
Domestic Private Sector	+416.5	+690.2	+792.1	+914.4	+1715.3
Adjustment for Shift to Time Deposits	-281.5	-279.6	-428.1	-496.9	-795.6
Net Private Sector	+135.0	+410.6	+364.0	+417.5	+919.7
Govt. Sector	+372.0	-114.1	+402.3	+421.2	+515.6
Adjustment for Counterpart Funds	-264.1	+403.9	-237.7	+205.5	-156.8
Net Govt. Sector	+107.9	+289.8	+164.6	+626.7	+358.8
Foreign Sector	-119.5 <sup>(1)</sup>	- 79.0	+273.5	-153.0 <sup>(2)</sup>	-356.9 <sup>(3)</sup>
I.B.R.D. Indus A/c.	"	-186.1	+ 54.2	+ 66.4	- 54.8
Other Factors	- 94.3	-212.8	- 9.9	- 71.2	-225.1
Total Causative Factors	+ 29.1	+222.5	+846.4	+1028.8	+681.7

(1) Adjusted for purchase of foreign currency from the I.M.F. (2) Adjusted for repurchase of local currency from I.M.F. (3) Adjusted for receiving a sum of \$16 million from I.M.F.

TABLE 31

Causative Analysis of Changes in Money supply (Third Plan)  
(Million Rupees)

Causative Factors July-June basis	1965-66	1966-67	1967-68
Changes in Money Supply	+1221.4	+ 540.7 <sup>(1)</sup>	+ 374.6
Domestic Private Sector	+ 366.3	+1935.9	+ 710.1
Adjustment for Shift to Time Deposits	- 810.8	-1101.4	- 793.0
Net Private Sector	- 444.6	+ 834.5	- 82.9
Government Sector	+1432.7	+ 32.8	+1032.2 <sup>(3)</sup>
Adjustment for Counterpart Funds	+ 246.8	- 40.7	- 347.0
Net Govt. Sector	+1679.5	- 7.9	+ 685.2
Foreign Sector	+ 153.9	- 493.1 <sup>(2)</sup>	+ 172.8 <sup>(4)</sup>
I.B.R.D. Indus Account	- 52.7	+ 60.2	- 4.5
Other Factors	- 144.6	+ 147.0	- 396.0
Total Causative Factors	+1221.4	+ 540.7	+ 374.6

(1) Adjusted for Industrial Development Bank of Pakistan foreign currency loans.

(2) Adjusted for devaluation of Indian Rupee, subscription to Asian Development Bank etc.

(3) Adjusted for retirement of ad hocs created on account of Indian Rupee devaluation and also for Pound Sterling devaluation.

(4) Adjusted for Pound Sterling devaluation, repayment of the drawings from I.M.F. etc.

Source: of Tables 35, 36 and 37 - Government of Pakistan, Economic Survey, 1968-69, Statistical Section, Table 14, pp.28-29.

transfer does not have any significant monetary implications. Consequently, in this study, we consider only government borrowings from the banking system adjusted for the changes in Government's cash balances with the State Bank of Pakistan as deficit financing. The quantities thus obtained are, however, adjusted for the changes in counterpart funds. An excess of releases from the counterpart funds over their accumulations in a given year is considered equivalent to an addition to deficit financing and vice versa. We call this estimate 'net deficit financing' in the Government sector. Both the Pakistan Planning Commission and the State Bank of Pakistan have interpreted the term deficit financing in this sense. In other monetary studies on Pakistan also this term has been used in a similar manner<sup>2</sup>.

Pakistan's First Plan had made a provision for public borrowings of Rupees 1500 million in the form of permanent and floating debt for financing public sector development expenditures. Government borrowings from non-banking institutions and general public were expected to be very small and the bulk of proposed borrowings during the Plan period were to come from the banking system. It was assumed by the planners that the real national income would rise by 15 per cent over the Plan period and absorb a substantial part of the monetary expansion caused by deficit financing so that the proposed amount of deficit financing would not have noticeable inflationary effects.<sup>3</sup> In reality, Government

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2. Cf. M. Haq, Deficit Financing in Pakistan, ( P.I.D.E Monograph No: 3, Karachi, 1961) and Parvez Hasan, Deficit Financing and Capital Formation: The Pakistan Experience, Op.Cit.

3. Cf. Government of Pakistan, Planning Commission, The First Five Year Plan Preliminary Evaluation Report, (September, 1959), PP. 11-12.

borrowings from the banking system and cash balance utilization (adjusted for counterpart funds) amounted to Rupees 1442 million in the First Plan period which were almost equal to the Plan target for deficit financing. Deficit financing was mainly concentrated in the first three years of the Plan as, with the implementation of the Plan, development expenditures in the Government sector rose sharply while tax revenues and aid inflows were still very meagre. In 1959, the military regime tried to curb the inflationary pressures and deficit financing was then greatly curtailed. In 1958-59, net deficit financing was considerably reduced as compared with the preceding two years and in 1959-60, the Government sector exercised a net contractive effect of Rupees 35 million on the money supply. The money supply increased by Rupees 1957 million over the Plan period registering a rise of about 51 per cent from its pre-Plan level and almost 74 per cent of this increase was due to the Government's deficit financing operations. Details of deficit financing in this period are given in Table 32. The sharp rise in prices in the First Plan period was to a great extent due to a high rate of deficit financing in addition to other factors like a serious food shortage and foreign exchange difficulties.

The draft document of the Second Plan proposed deficit financing of Rupees 1000 million and envisaged a rise of about 25 per cent in the money supply. With the proposed rise of 20 per cent in real national product (later raised to 24 per cent) and the rising demand for money in the economy, deficit financing of this order was considered to be within safe limits<sup>4</sup>. The revised version of the Second Plan, however, altogether discarded deficit financing

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4. Cf. Government of Pakistan, Planning Commission, The Second Five Year Plan, 1960-65, (June 1960), PP 61-62.



TABLE 52

Deficit Financing in the First Plan ( Million Rupees)

Year July-June basis	Borrowings from State Bank. Adjusted for Cash balance Utili- zation.	Borrowings from Commer- cial Banks.	Adjustment for Counter- part Funds	Net Deficit Financing	% to G.N.P.
1955-56	295.4	26.1	-155.2	166.3	0.7
1956-57	875.4	-13.3	-446.1	416.0	1.6
1957-58	472.0	234.5	- 35.8	670.7	2.7
1958-59	54.8	195.5	- 26.8	223.5	0.8
1959-60	58.8	64.2	-157.9	-34.9	-0.1
Total	1756.4	507.0	-821.8	1441.6	"

Source: Computed from State Bank of Pakistan, Reports on Currency and Finance and Monthly Bulletins.

as a cautious approach towards the price situation. This decision seemed to be justified in view of the severe pressure on prices in the First Plan period. But as the Plan proceeded, the Government took resort to deficit financing on the pretext that in view of the high rate of economic growth during the Plan period especially in the agricultural sector, some deficit financing would be non-inflationary. Consequently, net deficit financing totalled Rupees 1548 million over the Plan period and thus exceeded the First Plan aggregate by Rupees 106 million. Nevertheless, on account of the large size of the Plan, the share of deficit financing in public sector development expenditures declined from 20 per cent in the First Plan period to 11 per cent in this Plan. The money supply increased by Rupees 2809 million over the Plan period, registering a rise of about 48 per cent as against the Plan estimate of 25 per cent and about 55 per cent of this increase could be attributed to net deficit financing in the Government sector. The price situation, however, remained fairly stable in the Second Plan period as the economy maintained a reasonably high rate of economic growth which absorbed a substantial part of the monetary expansion and domestic supplies were liberally supplemented by imports made possible by the expanded foreign aid supplies and improved foreign exchange position. Table 33 gives the details of deficit financing in the Second Plan period.

Like the First Plan document, the Third Plan again proposed a sum of Rupees 15000 million to be raised through deficit financing for supplementing the public sector resources. It was claimed by the Planning Commission that this amount of deficit financing would be consistent with the expected increase in the demand for money and

the rise in real income. It was stressed that, in order to maintain the monetary ratio at its Second Plan level, the money supply must rise by Rupees 4000 to 5000 million. The proposed amount of deficit financing would, thus, leave ample scope for the private sector borrowings from the banking system. In fact, this amount of deficit financing was considered necessary to generate sufficient primary reserves in the banking system on which credit creation for the private sector could be based<sup>5</sup>.

As against the Plan proposals, there had already been net deficit financing of Rupees 2357 million by June 1968. The Plan projections of domestic and external resources were based on the expectation of normal conditions and growth of the economy as projected by the Plan. On the contrary, Pakistan's hostilities with India and consequent disruption in economic and political circumstances distorted the pattern of Government receipts and expenditures. On the one hand, defence expenditure almost doubled in 1965-66 and, on the other, foreign aid receipts were seriously reduced due to the changed attitude of the United States and other member countries of Pakistan Aid Consortium. Consequently, in addition to substantial increases in taxation, the quantum of deficit financing had to be increased sharply. In the first three years of the Third Plan, the share of deficit financing in the public sector development expenditures again increased to 19 per cent as compared with 11 per cent in the preceding Plan. However, a substantial part of internal credit expansion in this period was absorbed by heavy balance of payments deficits and depletion in foreign exchange reserves. Nevertheless, the money supply

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5. Cf. Government of Pakistan, Planning Commission, The Third Five Year Plan, 1965-70, ( June 1965 ) PP. 72-74.

TABLE 33

## Deficit Financing in the Second Plan (Million Rupees)

Year July-June basis	Borrowings from State Bank Adjusted for Cash Balance Utilization	Borrowings from Commercial Banks	Adjustment for Counterpart funds	Net Deficit Financing	% to G.N.P.
1960-61	109.5	262.5	-264.1	107.9	0.3
1961-62	- 78.1	- 36.0	+ 403.9	289.8	0.8
1962-63	296.8	105.5	-237.7	164.6	0.4
1963-64	84.6	333.6	+205.5	626.7	1.5
1964-65	288.9	226.7	-156.8	358.8	0.7
Total	701.7	892.3	- 49.2	1547.8	-

Source: Computed from, State Bank of Pakistan, Reports on Currency and Finance and Monthly Bulletins.

increased by Rupees 2137 million in the three years maintaining an average annual rate of growth of about 8.2 per cent. The details of deficit financing in the first three years of the Third Plan are given in Table 34.

Large-scale development programmes in Pakistan have resulted in increased Government liability to the banking system. In view of the mounting development and non-development expenditures of the central and provincial Governments in Pakistan, increasing resort has been taken to deficit financing. Quite often, the amount of net deficit financing in the Government sector far exceeded the provisions made for it in various Plans or in the annual budget. In fact, the claims of the banking system on the Government sector and excess withdrawals from counterpart funds have been greatly influenced by political circumstances and foreign aid inflows. Foreign aid has been an important source of financing Government development expenditures and whenever there were difficulties or delays in obtaining adequate quantities of it, reliance on deficit financing increased. Among the Government's recurring expenditures, defence expenditure has been very large and changes in it have also reflected in the size of deficit financing.

## 2. Bank Credit to Private Sector:

Monetary expansion in Pakistan has also been strongly influenced by the rapidly rising demand for bank credit in the private sector. With the increasing participation of private sector in the country's economic development and increasing investment in industry, the need for bank finance increased at a fast rate. In the pre-Plan period and in most of the First Plan period, the flow of bank credit to private sector was very low because the private sector

TABLE 34

Deficit Financing in the Third Plan (Million Rupees)

Year July-June basis	Borrowings from State Bank Adjusted for Cash Balance Utilization	Borrowings from Commercial Banks	Adjustment for Counterpart Funds	Net Deficit Financing	% to G.N.P.
1965-66	1248.2	184.5	+ 246.8	1679.5	3.3
1966-67	- 55.9	88.7	- 40.7	- 7.9	-0.01
1967-68	420.9	611.3	- 347.0	685.2	1.1
Total	1613.2	884.5	- 140.9	2356.8	-

Source: Computed from, State Bank of Pakistan, Monthly Bulletins andPakistan Economic Survey, 1968-69

investment was still small. But it picked up very sharply with relaxations in direct economic controls and a movement towards freer economy and the demand for bank credit on private account began to rise at a significant rate. Bank credit extended to the private sector in the First Plan period aggregated only to Rupees 731 million. Of the advances made to the private sector, nearly 43 per cent went to commerce and 38 per cent to manufacturing followed by other sectors. The expansionary effect of bank credit was, however, partly offset by a rise in time deposits of Rupees 427 million. After adjusting the credit expansion on private account for a shift to time deposits, the net contribution of the private sector to monetary expansion was only Rupees 304 million or 15.6 per cent of the total increase in the money supply in this period<sup>6</sup>.

In the Second Plan period ( 1960-65 ), bank credit to the private sector totalled Rupees 4300 million. As there was considerable increase in private sector investment during the Second Plan period, the demand for bank credit also increased at a sharp rate. Of the total bank loans extended to private sector, 39 per cent went to manufacturing and 37 per cent to commerce, followed by other sectors. However, the expansionary effect of bank credit to the private sector was partly offset by an increase in time deposits of Rupees 2282 million. Thus, the net contribution of the private sector to monetary expansion was of the order of Rupees 2018 million or 72 per cent of the aggregate monetary expansion. Internal credit expansion during this period was, however, greatly absorbed by deficits on external accounts.

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6. An increase in the non-monetary liabilities of commercial banks works as a leakage from the money supply and tends to offset the expansionary effect of credit creation by the banks for the private sector. It is, therefore a practice in Pakistan that while estimating the net contribution of the private sector to monetary expansion, any change in the demand deposits of scheduled banks on behalf of the private sector is adjusted for a shift to time deposits.

In the first three years of the Third Plan, bank credit to the private sector aggregated to Rupees 3012 million. Of this, manufacturing claimed nearly 45 per cent and commerce 35 per cent, followed by other sectors. There was a significant shift towards time deposits amounting to Rupees 2705 million which partly offset the expansionary effect of bank credit to the private sector. Thus the net contribution of private sector to monetary expansion was only Rupees 307 million or 14 per cent of the aggregate. Table 35 shows the flow of scheduled banks' credit to the private and public sectors during the period under study.

On the whole, bank credit to the private sector has increased at a fast rate since the Second Plan period. In addition to the increasing opportunities of private sector participation in productive activities, one reason for the rising demand for bank credit was the low cost of borrowing. Although the advances rate of scheduled banks increased over the period under study, the real rate did not rise much. The State Bank of Pakistan publishes a weighted average of the scheduled banks' advances rate since 1958 by type of securities. A simple average of these rates together with the real rate of interest is given in Table 36. With the rising opportunities of investment and relatively high profits, the low real rate of interest made borrowings more attractive.

Rapid expansion in bank credit was financed by the rising bank reserves and general increase in banks' liquidity. On the one hand, on account of Government's liberal deficit financing operations and increased State Bank lendings to commercial banks, bank reserves increased at a fast rate. On the



other, the public's currency-deposit ratio declined significantly in this period so that banks were able to attract more deposits and their liquidity increased at a fast rate. Moreover, a substantial shift towards time deposits took place in this period which enabled banks to extend longer term loans. Table 37 shows the growth of bank reserves and of high-powered money in the period under study while Table 38 shows the growth of commercial banks' borrowings from the State Bank of Pakistan and details about their reserve position. With increasing bank liquidity and a high demand for credit in the economy, the banks were able to create more credit. The values of the money multiplier increased substantially in this period mainly on account of the public's declining cash-deposit ratios. Table 39 gives the public's cash-deposit ratios, the banks' cash-deposit ratios and the values of the money multiplier.

### 3. Role of the External Sector:

Internal credit expansion on a large-scale and resulting inflationary pressures in a country almost invariably give rise to balance of payments deficits which tend to siphon off the inflationary effects of internal credit expansion both through their effect on the foreign assets holdings of the banking system and by supplementing the domestic supplies with required imports. In Pakistan, the deficits on external accounts and the resulting depletion of foreign exchange reserves have greatly cushioned the internal inflationary pressures created by ambitious development programmes. Attempts to industrialize reapidly almost always put pressure on the balance of payments of a country because of the increased demand for capital goods that have to be imported.

TABLE 35

Scheduled Banks' Credit to Private and Public  
Sectors, 1955-68, (Million Rupees)

<u>Last Friday of June</u>	<u>Private Sector</u>	<u>Public Sector</u>	<u>Total</u>
1955	738.1	146.0	884.1
1956	838.1	77.5	915.6
1957	1078.3	54.4	1132.7
1958	1107.3	118.2	1225.5
1959	1101.0	201.0	1302.0
1960	1458.3	159.1	1617.4
1961	1872.2	330.6	2202.8
1962	2534.9	326.6	2861.5
1963	3291.9	378.1	3670.0
1964	4186.0	605.3	4791.3
1965	5758.7	629.0	6387.7
1966	5984.2	606.8	6591.0
1967	7440.9	564.2	8305.1
1968	8518.0	887.2	9402.2

Source: State Bank of Pakistan, Currency and Finance Reports  
and Monthly Bulletins.

TABLE 36Scheduled Banks' Advances Rate % per annum(Average) 1958-68

Year End of June	Interest Rate	Real Interest Rate (Deflated by G.N.P. Deflator).
1958	4.2	3.3
1959	5.0	4.1
1960	5.3	4.0
1961	5.4	4.0
1962	5.6	4.1
1963	5.8	4.1
1964	5.6	4.0
1965	6.6	4.5
1966	6.9	4.6
1967	7.2	4.3
1968	7.5	4.5

Source: State Bank of Pakistan, Monthly Bulletins.

TABLE 37

Growth of High-Powered Money 1955-68

(Million Rupees)

Year	Cash with The Public	Cash in Banks' Tills	Scheduled Banks' balances with the State Bank	Total
1955-56	2981.6	49.5	187.8	3218.9
1956-57	3372.8	53.3	264.3	3690.4
1957-58	3581.7	51.7	141.4	3774.8
1958-59	3597.9	69.3	193.8	3861.0
1959-60	3772.1	81.8	252.9	4106.8
1960-61	3806.2	83.0	172.6	4061.8
1961-62	3824.9	95.2	184.0	4104.1
1962-63	4081.5	129.8	207.2	4418.5
1963-64	4612.1	149.4	262.5	5024.0
1964-65	4902.1	166.1	359.6	5427.8
1965-66	5802.0	230.1	574.0	6606.1
1966-67	5561.7	350.9	475.9	6388.5
1967-68	5783.0	310.5	719.8	6813.3

Source: Computed from State Bank of Pakistan, Currency and Finance Reports and Monthly Bulletin.

TABLE 38

## Scheduled Banks' Borrowings from the State Bank of Pakistan and

## Their Reserve Position, 1955-68 (Million Rupees)

Last Friday of June	Borrowings from S.B.P.	Statutory Reserves	Excess Reserves	Net Free Reserves
1955	9.8	79.2	108.6	146.5
1956	28.3	87.7	176.6	197.8
1957	93.0	93.7	47.7	8.0
1958	38.7	107.0	86.8	99.8
1959	9.9	115.9	137.0	196.4
1960	11.2	127.2	52.9	105.6
1961	337.6	133.8	50.2	-204.4
1962	403.2	154.6	52.6	-255.4
1963	385.8	196.0	66.5	-189.5
1964	783.0	308.8	50.8	-582.8
1965	1688.2	542.0	32.0	-4489.9
1966	1078.5	429.6	46.3	- 833.9
1967	1784.1	650.9	68.9	-1359.3
1968	1832.4	673.0	21.9	-1422.0

Source: State Bank of Pakistan, Monthly Bulletins and Banking Statistics of Pakistan

TABLE 39

The Values of Money Multiplier 1955-68

Year	$\alpha$	$\beta$	$\alpha + \beta$	$\frac{1}{\alpha + \beta}$
1955-56	2.08	0.17	2.25	0.45
1956-57	2.26	0.21	2.47	0.40
1957-58	2.12	0.11	2.23	0.45
1958-59	1.92	0.14	2.06	0.49
1959-60	1.88	0.12	2.00	0.50
1960-61	1.91	0.13	2.04	0.49
1961-62	1.74	0.13	1.87	0.53
1962-63	1.46	0.12	1.58	0.63
1963-64	1.40	0.13	1.53	0.65
1964-65	1.34	0.14	1.48	0.68
1965-66	1.47	0.20	1.67	0.60
1966-67	1.18	0.17	1.35	0.74
1967-68	1.18	0.21	1.39	0.72

Source: Computed from Tables 28 and 37.

$\alpha$  = public's cash - deposit ratio.

$\beta$  = banks' cash - deposit ratio.

Moreover, import substitution, through high tariffs and import quotas, is always biased against exports in so far as attention is focussed mainly on foreign exchange saving rather than on foreign exchange earning projects. Serious current account deficits are, therefore, experienced in those under-developed countries where industrialization programmes are going on and whose exports are inadequate to meet the demand for imports. The current account deficits on balance of payments are partly met from foreign capital inflows but often the foreign exchange reserves of the country also tend to be depleted.

Pakistan has experienced balance of payments difficulties from the very outset. Deficits began to appear after the middle of 1948 when under the Open General License system, imports were high and large quantities of defence and other stocks were being purchased on Government account. During the Korean War boom of 1950-51, however, the country was able to build up substantial foreign exchange reserves. After the war was over, exports began to decline again and terms of trade deteriorated due to recessionary tendencies in the world commodity markets. Consequently, deficits re-emerged from 1951-52 and grew larger as earnings declined faster than payments. As the inflow of external resources was, at that time, very meagre, foreign exchange reserves were seriously depleted. Consequently, the Open General License which had existed since the emergence of Pakistan had to be discontinued in the later half of 1952 and import restrictions were imposed. With the devaluation of Pakistan rupee in August 1955, however, the balance of payments position improved. The value of exports increased by 10 per cent while payments for private imports declined significantly. But the advantage of devaluation proved to be short-lived and the

declining trend in exports was resumed in 1956-57 and was intensified in 1957-58. Industrial growth in the country aggravated the effect of internal inflationary pressures on the balance of payments by diverting export goods to home consumption. This was particularly true of raw cotton where there was a growing absorption in domestic industry without a corresponding increase in the export of cotton manufactures<sup>7</sup>.

By 1957-58, the country's foreign exchange reserves had fallen to an extremely low level and in order to overcome the foreign exchange crisis, the Government was advised by some foreign experts to introduce import surcharges and auctioning of foreign exchange<sup>8</sup>. Consequently, in 1959, the export bonus scheme was introduced under which the exporters of specified goods were given transferable import licenses valuing a certain percentage of their export earnings ( the percentage varied according to the type of goods exported ). Incentive to the exporters was provided by the large premium that these licenses earned in the open-market<sup>9</sup>. With the introduction of this scheme and also with an improvement in the terms of trade, the country had a substantial current account balance of payments surplus in 1959-60.

On the whole, the foreign exchange position in the First Plan period was very poor. The Plan document had projected total foreign exchange earnings over the Plan period at Rupees 10,500 million but actual earnings turned out to be about 10 per cent less

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7. Cf. Parvez Hasan, "Balance of Payments Problems of Pakistan", Pakistan Development Review, Vol.I N:2, 1961.

8. Cf. J.R. Parkinson, "The Balance of Payments and Fiscal Policy in Pakistan", Scottish Journal of Political Economy, Vol. 9, 1962.

9. For details see, Henry J. Bruton and S.R. Bose, The Pakistan Export Bonus Scheme, ( P.I.D.E, Monograph, No. II, Karachi, 1963.



than the Plan estimation. Consequently the foreign exchange expenditure had to be seriously curtailed and investment programmes in industry and transport suffered enormously. A part of the industrial capacity had to remain idle due to inadequate supplies of capital goods and raw materials.

The current account deficits revived again in the following year and continued throughout the Second Plan period becoming more significant in the later part of the Plan. As considerable import liberalization took place during the Plan period, imports increased at a fast rate and serious current account deficits were experienced in all years of the Plan. Nevertheless, as the quantum of external resources increased by about 60 per cent during this period as compared with the First Plan, the foreign exchange reserves were not much affected except in the last year of the Plan when due to a large current account deficit, they were significantly depleted.

In the first three years of the Third Plan again, the country experienced serious current account deficits. On the one hand, defence imports increased substantially in the first year of the Plan due to Pakistan's armed conflict with India. On the other hand, there was a serious food shortage in the country in the first two years of the Plan and with substantial cut-backs in the P.L. 480 food imports, a large part of the country's own scarce foreign exchange had to be spent on food imports. Consequently, development imports suffered a lot and import controls had to be tightened in order to restrain private non-development imports. On account of large current account deficits and cut-backs in foreign aid, the country's foreign exchange reserves were seriously depleted and were at their lowest level in these three years. The terms of trade also deteriorated sharply in

this period except in 1966-67 when they improved by about 25 per cent.

Over the period as a whole, the country's imports increased at a much faster rate than her exports. Table 40 gives the ratio of exports and imports to the gross national product. While the export ratio declined significantly, that of imports increased substantially. These ratios, however, conceal the terms of trade effect. Table 41 shows the changes in the country's terms of trade during the period under study and the movements of real exports and real imports at 1954-55 prices are shown in Table 42. While imports increased at a fast rate because of high development and food imports, exports failed to increase rapidly because of the diversion of exportables to home consumption under excess demand conditions.

As the foreign exchange expenditure far exceeded the foreign exchange receipts including capital inflows, the foreign exchange reserves were significantly depleted over the period under study. Considering the current account balance of payments, the capital inflows and all other external transactions, the external sector contributed a net addition of Rupees 287 million to the money supply in the First Plan period. This addition took place only in three years, namely 1955-56, 1958-59 and 1959-60. In the first year of the Plan, because of devaluation of rupee, the country's foreign exchange earnings increased significantly and these together with capital inflows contributed a net addition of Rupees 444.5 million. In the following two years, the external sector contributed a net contractive effect of Rupees 217 and Rupees 282 million. In the next two years again the external sector exercised a net expansionary effect of Rupees 122 and Rupees 220 million because of the fact that,

TABLE 40

Ratio of Exports and Imports to G.N.P. in per cent.

Year	Export Ratio	Import Ratio
1955-56	7.8	5.8
1956-57	6.0	8.7
1957-58	5.0	7.2
1958-59	4.7	5.6
1959-60	5.8	7.8
1960-61	5.1	9.1
1961-62	5.0	8.5
1962-63	5.7	9.9
1963-64	5.5	10.7
1964-65	5.2	11.8
1965-66	5.4	8.4
1966-67	4.9	8.9
1967-68	5.0	8.0

Source: Computed from C.S.O., Monthly Statistical Bulletins.

TABLE 41Indices of Import and Export Prices and Terms of Trade.

1954-55 = 100

Year	Import Prices	Export Prices	Terms of Trade	% Change in Terms of Trade
1955-56	138.0	118.8	86.1	-14.0
1956-57	170.9	131.8	77.1	-10.5
1957-58	168.5	143.4	85.1	+10.4
1958-59	161.4	128.3	79.5	- 7.0
1959-60	157.8	126.5	80.2	+ 0.9
1960-61	168.9	186.0	110.2	+37.0
1961-62	160.4	156.0	97.3	-11.8
1962-63	168.9	144.3	85.5	-12.3
1963-64	159.4	142.2	88.6	+ 3.5
1964-65	141.4	157.9	111.7	+25.8
1965-66	167.6	158.5	94.6	-15.1
1966-67	157.4	185.9	118.1	+25.2
1967-68	159.6	162.1	101.6	-14.4

Source: C.S.O., Monthly Statistical Bulletins.

TABLE 42

Real Imports and Exports, 1954-55 Prices (Million Rupees)

Year	Imports (Current Prices)	Imports (1954-55 Prices)	Exports (Current Prices)	Exports (1954-55 Prices)
1955-56	1325.1	960.0	1783.7	1499.0
1956-57	2334.6	1365.0	1607.6	1218.0
1957-58	2050.0	1213.0	1421.7	994.0
1958-59	1578.4	980.0	1325.3	1035.0
1959-60	2461.0	1558.0	1832.0	1443.0
1960-61	3187.6	1886.0	1786.4	960.0
1961-62	3109.1	1943.0	1824.6	1169.0
1962-63	3818.8	2259.0	2223.1	1544.0
1963-64	4430.2	2786.0	2280.3	1617.0
1964-65	5374.2	3811.0	2395.4	1516.0
1965-66	4208.3	2505.0	2691.0	1692.0
1966-67	5192.3	3307.0	2870.9	1543.0
1967-68	4691.0	2750.0	3084.0	1786.0

Source: Computed from C.S.O., Pakistan Statistical Year Books.

with the introduction of the export bonus scheme, the country's export earnings increased significantly. These, together with foreign aid inflows, contributed to the rise in the money supply.

In the Second Plan period, however, the external sector exercised a net contractive effect of Rupees 440 million on the money supply. In all years of the Plan, except 1962-63, a significant contractive effect was exercised by the external sector because of the fact that serious current account deficits were experienced by the country in these years which exceeded foreign capital inflows. In 1962-63, however, there was a sharp increase in foreign aid because of liberal pledges by the Pakistan Aid Consortium for financing the Second Plan and the external sector was able to add Rupees 273 million to the money supply. In all other years of the Plan, the external sector partly cushioned the inflationary effects of internal credit expansion.

In the Third Plan period also, in the three years under study, the external sector exercised a net contractive effect of Rupees 166 million on the money supply. In 1965-66, the external sector was able to make a net addition of Rupees 154 million to the money supply as transfer and capital receipts exceeded and more than made up the current account deficit on visible and invisible items. Both development and non-development imports were severely restricted in this year because of Pakistan's war with India. On the other hand, exports were maintained and other receipts, particularly transfer payments, also remained high. Although the quantum of foreign aid was reduced in this year, still the foreign exchange reserve position was not much affected by it. In the following year, however, the external sector exercised a net contractive effect of Rupees 493 million as with the liberalization of

imports, payments on goods and services far exceeded receipts including those under transfer items and capital inflows. In 1967-68, however, the external sector added Rupees 173 million to the money supply as foreign aid inflows to Pakistan were restored almost to their former level. Table 43 gives a summary of the balance of payments on current account and the foreign exchange reserve position. Details of balance of payments position are given in the Statistical Appendix. Chart IV presents the indices of terms of trade and foreign exchange reserves graphically.

On the whole, the external sector has tended to siphon off the internal inflationary pressures in Pakistan. On the one hand, balance of payments deficits and depletion of foreign exchange reserves have exercised a contractive effect on money supply in several years under study and on the other, imports have heavily supplemented the domestic output bringing thereby a moderating effect on the price situation. The price level rose rapidly whenever foreign exchange difficulties were severe and imports were seriously restricted. Despite import restrictions of various kinds, the ratio of imports to income rose substantially during the period under study. In the Second Plan period especially, there was considerable import liberalization resulting in a substantial rise in import ratio which tended to moderate the impact of the increased money supply on domestic prices. The same story is told by the ratio of money to imports which is given in Table 44. Assuming a stable demand for money and an open economy, monetary expansion is most likely to increase imports and thereby affect the balance of payments. But when import restrictions exist in an economy, this may or may not be true. However, if imports increase at a fast rate in relation to the money supply, the effect of monetary expansion on the price level would be greatly reduced.

TABLE 43

Balance of Payments on Current Account and Foreign ExchangeReserves, (Million Rs.)

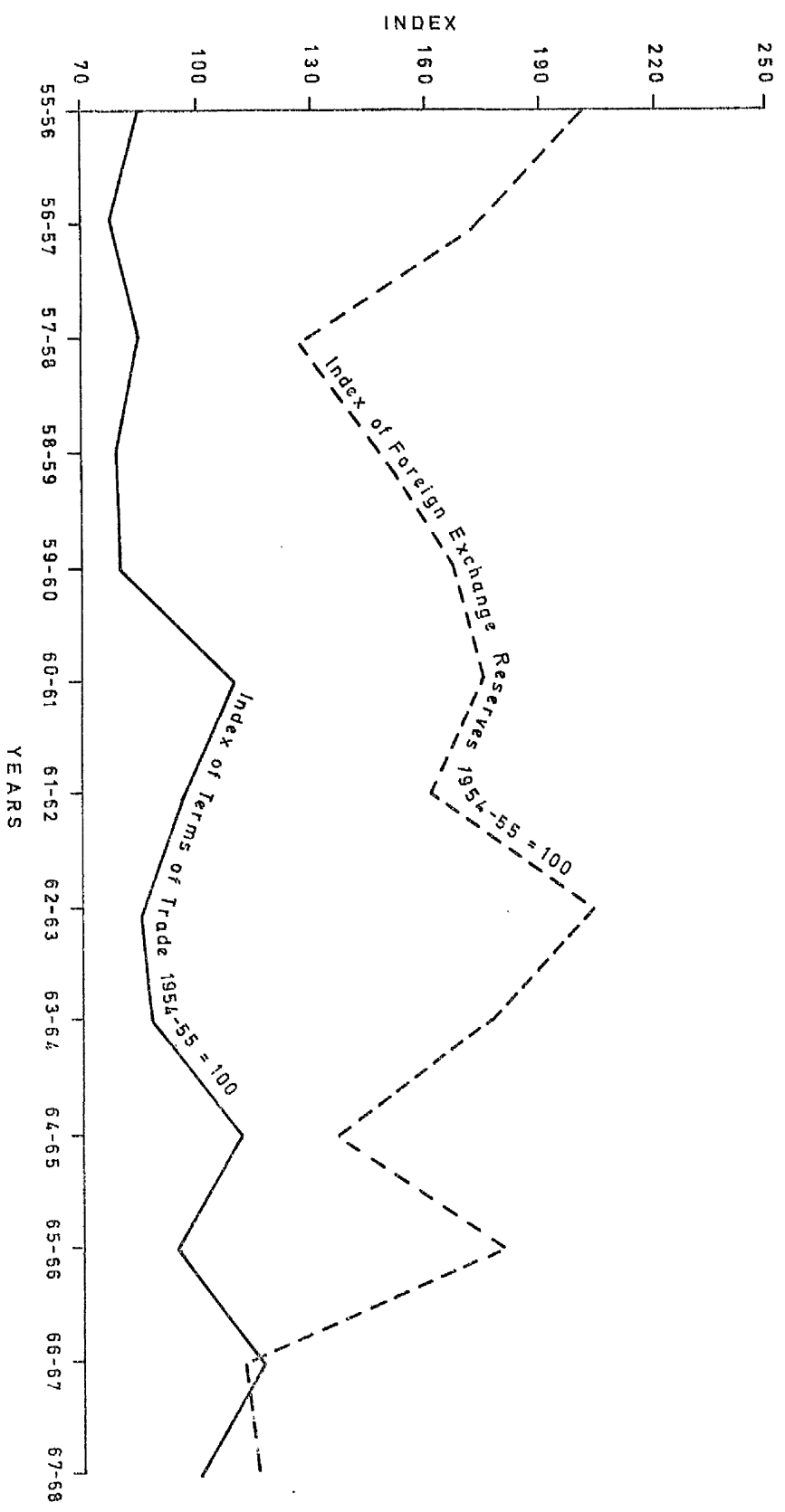
Year	Balance of Payments	Ratio to G.N.P. in %	Gold, Dollar and Sterling Reserves (End of June)	Ratio to G.N.P. %
1955-56	+ 361.8	+1.6	1394.6	6.1
1956-57	- 269.1	-1.0	1200.5	4.5
1957-58	- 335.7	-1.2	880.5	3.1
1958-59	+ 35.0	+0.1	1043.2	3.8
1959-60	+ 118.1	+0.3	1169.6	3.7
1960-61	- 55.5	-0.1	1225.0	3.5
1961-62	- 101.3	-0.3	1128.3	3.1
1962-63	- 87.8	-0.2	1436.2	3.7
1963-64	- 933.1	-2.2	1235.3	3.0
1964-65	-1582.6	-3.5	951.7	2.1
1965-66	-1247.0	-2.5	1263.3	2.6
1966-67	-2043.3	-3.5	793.2	1.3
1967-68	-1609.7	-2.6	816.4	1.3

Source: Computed from, State Bank of Pakistan, Reports on  
Currency and Finance and Monthly Bulletins.



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CHART IV



INDEXES OF TERMS OF TRADE AND FOREIGN EXCHANGE RESERVES

TABLE 44RATIO OF MONEY TO IMPORTS

YEAR	RATIO
1955-56	3.4
1956-57	2.1
1957-58	2.6
1958-59	3.5
1959-60	2.3
1960-61	1.8
1961-62	1.9
1962-63	1.8
1963-64	1.8
1964-65	1.6
1965-66	2.3
1966-67	2.0
1967-68	2.2

Source: Computed from Tables 28 and 42.

This is because, imports supplement domestic supplies directly and also enable fuller utilization of domestic productive capacity by providing the required capital equipment and raw materials. There is, however, another aspect of import liberalization, namely that it may bring an increase in income velocity as opportunities of investment and spending increase in the economy and this would add to the inflationary pressures. In fact, the real effect of import relaxation would be a combination of these two effects. However on the whole, it may be assumed that adequate supplies of foreign exchange and improved supplies of imports would normally bring about a moderating effect on the over-all price situation.

#### 4. Demand for Money and Income Velocity:

Monetary expansion in Pakistan, caused mainly by the Government's deficit financing operations and bank credit to the private sector, was also often supplemented by a rise in income velocity. Over the period as a whole, the money-income ratio remained more or less stable but there were significant marginal changes in it. Of the variables generally supposed to influence the demand for real cash balances in an economy, interest rates, particularly the long-term bond rate, do not seem to have influenced the demand for real cash balances in Pakistan to a significant degree. This is because interest rates have not changed much during the period under study and have not exerted any significant speculative effect on the demand for real cash balances. The demand for real cash balances in Pakistan seems to be primarily of a transactions and precautionary nature and has thus been a stable function of the level of real income. Price

changes would have influenced the demand for real cash balances through the inflation tax reaction of the public but the more important price effect seems to be through the changes in food prices. When crops are bad and food prices rise, urban families try to maintain their real consumption of food by increasing their expenditure on it while the rural producers increase their hoards more than in proportion to the decline in their output for speculative reasons. Income velocity of money therefore increases at the time of bad harvests<sup>10</sup>.

Data about the demand for real cash balances in Pakistan are given in Tables 45 and 46. These tables indicate that real cash balances have been a fairly stable function of the level of real income and that the money-income ratio has fluctuated within a narrow range of 0.166 and 0.198. The marginal changes in money-income ratio can, however, be explained in the following manner: (1) The ratio has declined sharply after every peak which shows that the public adjusted their real cash balances to the desired level with some lag (possibly of a year). Whenever monetary expansion was high, say on account of large deficit financing operations of the Government, money balances accumulated with the public till they adjusted them to the desired level by increasing their spending in the following year, (2) Spending opportunities in the economy were greatly determined by the tightening or relaxation of direct economic controls specially import controls and the money-income ratio was greatly influenced by these changes. Whenever direct controls were relaxed, the public increased their aggregate spending and income velocity rose and vice versa, (3) Income velocity increased in the event of

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10. Cf. R.C. Porter, "Income Velocity And Pakistan's Second Plan", Op. Cit.

## Basic Data About Demand for Money in Pakistan

Year July-June	Nominal Money (Million Rs.)	Money Nation- al Income (Million Rs.)	Long-term Bond Rate % per annum	Real Money+ (Million Rs)	Real National <sup>+</sup> Income
1953-54	3584.8	21836	3.12	3480.6	21200
1954-55	3856.0	21147	3.14	3856.0	21147
1955-56	4485.4	22658	3.15	4195.9	21176
1956-57	4951.2	26593	3.17	4167.8	22385
1957-58	5316.9	28400	3.20	4239.9	22649
1958-59	5511.4	28023	3.22	4539.9	23083
1959-60	5812.9	31439	3.37	4403.7	23817
1960-61	5842.0	34786	3.59	4215.0	25098
1961-62	6064.5	36485	3.75	4416.9	26573
1962-63	6910.9	38642	3.88	4939.9	27621
1963-64	7939.7	41284	3.91	5728.5	29786
1964-65	8621.4	45535	3.91	5937.6	31360
1965-66	9842.9	49690	4.48	6484.1	32734
1966-67	10383.6	58203	4.47	6097.2	34177
1967-68	10758.0	61608	4.47	6418.8	36759

+ Deflated by the implicit national income deflator, 1954-55=100.

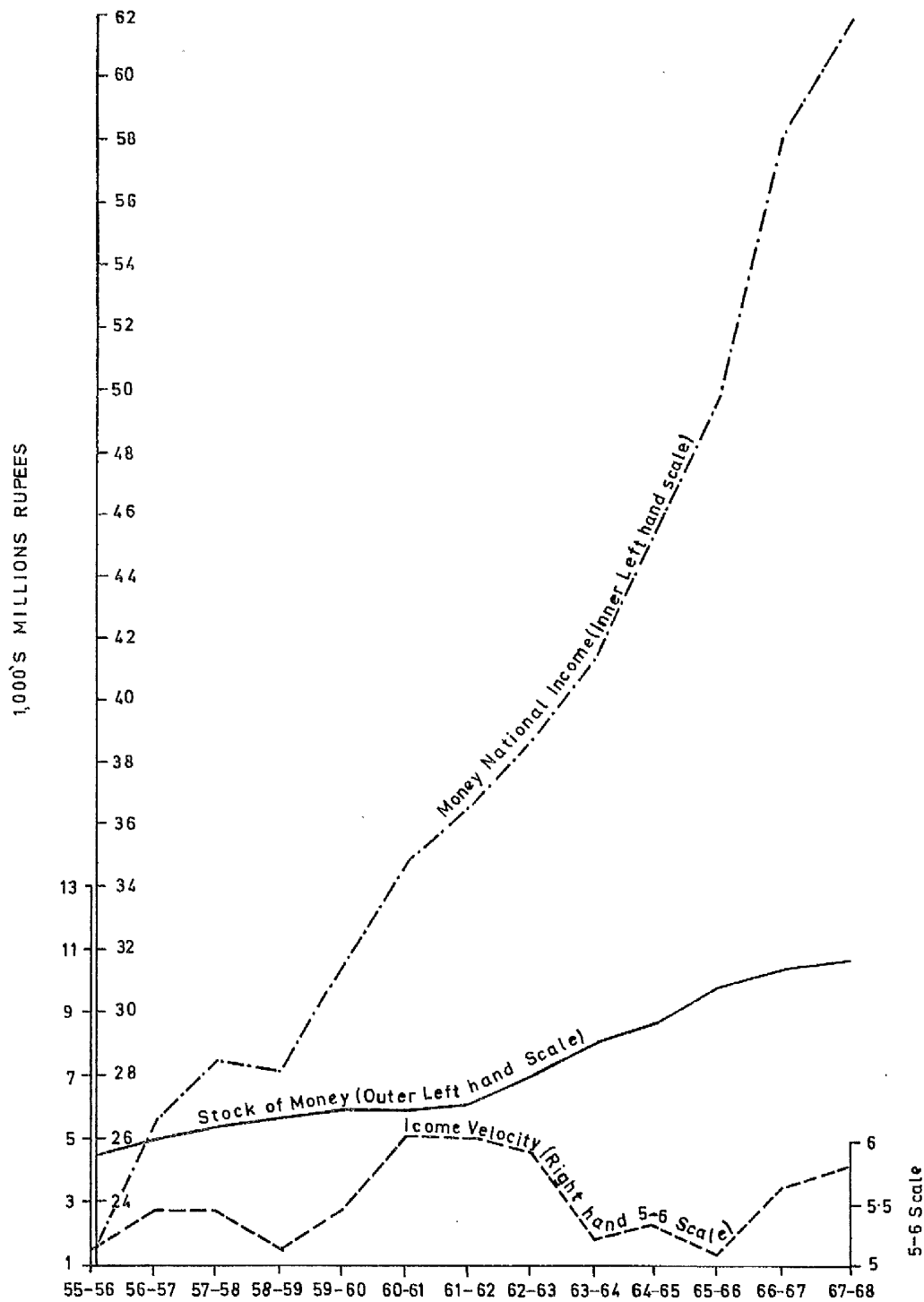
Source: United Nations, Monthly Bulletins of Statistics and Govt. of Pakistan Economic Surveys.

TABLE 46Money-Income Ratio and Income Velocity

Year	Ratio of Money to Income - M/Y	Income Velocity Y/M
1955-56	0.198	5.05
1956-57	0.186	5.38
1957-58	0.187	5.38
1958-59	0.197	5.08
1959-60	0.185	5.40
1960-61	0.168	5.95
1961-62	0.166	6.02
1962-63	0.179	5.86
1963-64	0.192	5.20
1964-65	0.189	5.29
1965-66	0.198	5.05
1966-67	0.178	5.62
1967-68	0.174	5.75

Source: Computed from Government of Pakistan, Economic Survey, 1967-68.

CHART V



STOCK of MONEY, MONEY INCOME and INCOME VELOCITY in PAKISTAN 1955-68

rising food prices as the consumption expenditures on food increased<sup>a</sup> in the years of poor crops and part of the marketable food surpluses were held back by foodgrain producers themselves for speculative reasons.

Moreover, there has occurred a gradual process of monetization in the non-monetized sector of Pakistan's economy. Marketed agricultural surpluses, especially of cash, crops have increased substantially over the period and more bank branches have been opened in the rural areas. Payments that used to be made in kind are being increasingly made in cash. Cash purchases of inputs by farmers have been rising. The monetization of these transactions does not affect the national income estimates because the latter include the imputed value of non-monetary transactions but it certainly does affect the demand for money and hence the income velocity. However, there is a consensus of opinion among economists in Pakistan that this factor has not been very important in determining the demand for real cash balances in comparison with other factors stated above.

Chart V graphically presents the rise in money supply, the changes in income velocity and the money national income during the period under study. It is evident from this chart that income velocity increased sharply during the period 1959-60 to 1962-63 when direct controls were greatly relaxed. It again rose significantly between 1966-67 and 1967-68 when import controls were once again relaxed, after the foreign exchange crisis due to cut-backs in foreign aid was over.

The money-income ratio was rising steadily in the pre-Plan period due to the fact that while monetary expansion was fairly high on account of Government's deficit financing operations, spending



opportunities in the economy were greatly curbed by the existence of direct economic controls. This trend continued up to 1955-56 but in the following two years, the income velocity increased significantly as, with the implementation of the First Plan, monetary expenditures in the public and private sectors increased rapidly. Income velocity declined again in 1958-59 when the newly established military regime strengthened direct economic controls and curbed the speculative activities. Monetary turnover, therefore, declined significantly and money balances remained accumulated with the public. But these restrictions were short-lived and from 1959-60, a movement towards a freer economy took place. Income velocity then rose again in the following three years. In 1962-63, the velocity again declined as monetary expansion was very high in these years and money balances accumulated with the public in a larger amount than what they wished to hold so that in the following year they adjusted their real cash balances to the desired level by increasing their expenditures. Consequently, the income velocity increased in 1964-65. But in 1965-66, once again the money-income ratio rose when, due to Pakistan's war with India, deficit financing was very large while spending opportunities were greatly restricted due to foreign exchange difficulties. As the foreign exchange position improved subsequently and import controls were relaxed, income velocity again rose in 1966-67 and 1967-68.

The capacity of the economy to absorb monetary expansion was obviously determined by the changes in real income and the money-income ratio. When the rate of economic growth was high, even large monetary expansion was easily absorbed without any significant effect on the price level. Similarly when the money-income ratio

TABLE 47  
MONETARY EXPANSION, MONETARY ABSORPTION AND PRICE CHANGES

Year	Changes in Money Supply (Million Rupees)	Money-income Ratio	Monetary Absorption Due to Output Changes (Million Rupees)	Monetary Absorption Due to Changes in Money-income Ratio (Million Rupees)	Changes in Price Level % (G.N.P. Deflator)
1954-55	-	0.182	-	-	-
1955-56	629.4	0.198	- 13.5	445.5	6.9
1956-57	465.8	0.186	329.3	-353.9	11.1
1957-58	365.7	0.187	41.3	29.7	5.5
1958-59	194.5	0.197	79.5	301.4	- 3.2
1959-60	301.5	0.185	255.1	-377.3	8.7
1960-61	229.1	0.168	304.7	-562.5	5.0
1961-62	225.5	0.166	328.8	- 70.1	- 0.9
1962-63	846.4	0.179	206.0	471.7	1.9
1963-64	1028.8	0.192	537.0	510.7	- 1.0
1964-65	681.7	0.189	340.6	-1123.2	4.0
1965-66	1221.4	0.198	360.9	386.7	4.5
1966-67	540.7	0.178	428.7	-902.7	12.1
1967-68	374.6	0.174	605.7	-194.1	- 1.5

Source: Computed from Tables, 15, 28 and 46.

rose indicating a larger demand for real cash balances at a given level of income, monetary expansion did not affect the price level much. On the contrary, when monetary expansion was supplemented by a rise in income velocity, price rises were quite significant. Table 47 shows the joint effect of monetary expansion, changes in real income and the money-income ratio on the price level.

In 1955-56, the money supply increased by Rupees 629 million and this was greatly absorbed by a rise in the money-income ratio but at the same time there was a decline in output in that year so that the national income price index indicated a rise of 6.9 per cent. On the other hand, in the following year, monetary expansion of Rupees 466 million took place and a large part of it was absorbed by a high rate of economic growth of 6 per cent but as income velocity increased sharply in that year, the national income deflator recorded a rise of 11 per cent. In 1959-60 also the money supply increased only by Rupees 301 million and real income rose by 4.3 per cent but income velocity again increased sharply in that year so that the price level went up by 8.7 per cent. In 1960-61 again the monetary expansion was only nominal namely Rupees 29 million and real income rose by 5.2 per cent but due to relaxations in direct economic controls, income velocity rose significantly and therefore the national income price index showed a rise of 5 per cent. In 1966-67 also when the price increase was the highest namely 12.1 per cent, it was the sharp rise in income velocity that influenced the price level most.

On the contrary, in certain years, monetary expansion was very high but prices did not rise much due to its absorption by a decline in income velocity. For example, in 1963-64, monetary expansion was large, namely Rupees 1029 million but both real income and the money-income ratio increased sharply so that the national

income price index recorded a decline of 1 per cent. Likewise, in 1965-66, monetary expansion was the highest namely Rupees 1221 million, but income velocity declined significantly due to the shortage of foreign exchange and therefore the G.N.P deflator showed a rise of only 4.5 per cent.

Thus both monetary expansion and changes in income velocity have played a significant role in exerting inflationary pressures in the economy of Pakistan. These supplemented the inflationary effects created by food shortages and foreign exchange difficulties. The monetary factors were obviously the outcome of the fiscal and monetary policies pursued during the period under review and were to a great extent controllable. An appraisal of the fiscal and monetary policies in Pakistan is, therefore, essential and is done in the following chapter.

CHAPTER VIAN APPRAISAL OF FISCAL AND MONETARY POLICIES1. The Fiscal Policy:

Governments in under-developed countries often find it easy to finance their economic development programmes by borrowing from the banking system without caring much for its inflationary implications. This coupled with monetary expansion initiated by private sector borrowings from the banking system, generally have serious inflationary effects. Unless monetary expansion is fully matched by a rise in real income especially in the key sectors of the economy and a rise in the demand for money, the pressure on prices is inevitable. Governments in these countries can collect more money through increased taxation but this is often resisted for fear of political opposition. Likewise, there is a tendency among the underdeveloped countries to minimize external borrowings. Consequently, inflationary financing becomes unavoidable and pressure on prices is eventually felt. Our purpose in this section is to show that deficit financing in Pakistan could be greatly curtailed by making adequate efforts to raise additional tax revenues but this was not adequately done. Governments in the past were reluctant to tap the rich tax-payers fully and even when the rates of taxation were high on paper, the total amount collected was rather small due to evasions, corruption and other malpractices. Some of the deficiencies in Pakistan's tax-structure and the possibilities of raising additional tax revenues are discussed below.

The central and provincial budgets in Pakistan are divided into two distinct parts namely the revenue budget and the capital budget. The revenue budgets cover current, recurring and administrative expenditures. This part of the budget is financed from taxation, surpluses of public enterprises and other current receipts. On the other hand, the capital budgets cover expenditures which result in the creation of capital assets or loans and advances to the provinces and local bodies for the same purpose. It is financed chiefly from internal borrowings and foreign aid. The surpluses on revenue account are also a source of financing the capital expenditures. In the first decade of Pakistan's existence, the revenue receipts were very meagre while administrative expenditures were rising at a fast rate so that the central and provincial Governments had to take increasing resort to deficit financing and the budgets could not show any significant revenue surpluses. In the First Plan period, aggregate tax revenues of the Government constituted only about 7 per cent of the G.N.P. while development and non-development expenditures were rising at a fast rate. In 1948-49, the combined expenditure of the central and provincial Governments was below Rupees 1500 million; in 1957-58 it rose to Rupees 4667 million. The development expenditure alone stood at Rupees 2128 million in this year. Public savings were almost negligible in the First Plan period and about one-fifth of the public sector development expenditures were financed by deficit financing and fifty per cent by foreign aid. The tax structure was very simple and it was not fully responsive to the fiscal needs of a developing economy. Nearly 70 per cent of all government revenues were derived from indirect taxes. The coverage of income tax was deplorably low,

namely only about 0.26 per cent of gainfully employed population paid income tax. Tax yields from the agricultural sector were specially small and returns from urban property taxes were negligible. Among indirect taxes, customs duties and sales tax were the main sources of government revenue. Excise duties were mainly specific and had not been adjusted for price increases for a long time. The Government had appointed a Taxation Enquiry Committee in 1960 which made some useful recommendations but these were not fully implemented for political reasons<sup>1</sup>. Attempts were made to curtail deficit financing towards the end of the First Plan but in the absence of adequate tax revenues, resort had to be taken to it again in the Second Plan.

Development expenditures of the public sector accelerated further during the Second Plan period and attempts were made to raise additional tax revenues and to reduce non-development expenditures. Three new direct taxes were introduced in 1963-64 namely a wealth tax, a capital gains tax and a gifts tax. All these taxes had high exemption limits and were intended to tax only the rich taxpayers. At the same time, a substantial increase in indirect taxes was also effected during the Second Plan period. The coverage of excise duties was widened and their rates were enhanced. Likewise, the rates of sales tax and customs duties were also increased. The import duties on liberalized imports were increased by about 10 per cent ad valorem. As a result of the increased tax efforts,

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1. The main recommendations of the Committee were the following:
    - (1) Lowering of exemption limit for personal income tax from Rupees 6000 to the levels of average family incomes in the country.
    - (2) Raising of the minimum rate of estate duty and,
    - (3) Reduction of tax concessions to new industries in view of enough protection provided by tariffs, import licenses and exchange control system.

Cf. The Taxation Enquiry Committee Report, Vol.I, (Karachi, 1961).

additional Rupees 1850 million were collected through new taxation in the Second Plan period. The ratio of tax revenues to the G.N.P also increased from 7 per cent in the First Plan to 9 per cent in this Plan. Moreover, the central and provincial Government budgets began to show significant revenue surpluses and their share in development finance increased substantially. Correspondingly, the share of deficit financing in the public sector development expenditures declined from 20 per cent to 11 per cent and that of external resources from 50 per cent to 49 per cent.

The emphasis on mobilization of domestic resources for economic development continued in the Third Plan period as well. There was substantial increase in taxation in the first three years of the Plan especially in 1965-66 which was necessitated by a serious cut-back in foreign aid and a rise in defence expenditure in the early part of the Plan. The central and provincial budgets also showed significant revenue surpluses in these year, except in 1965-66 when defence expenditure almost doubled. However, the ratio of tax revenues to the G.N.P still remained below 10 per cent. While the share of external resources in public sector finances further declined to 48 per cent, that of deficit financing increased to 19 per cent.

Over the period as a whole, due to rapid increase in the central and provincial taxes particularly since the Second Plan period, the tax system has shown a high income-elasticity. The computed elasticity is as follows:

$$\text{Log } T = - 2.79511 + 1.36632 \text{ Log } Y \\ (0.09186)$$

$$R = 0.976 \quad R^2 = 0.960$$

T = Tax revenues,

and,

Y = Gross national product in current prices.



Tables 48, 49 and 50 give the cross-section data on the budgetary position of central and provincial Governments. Table 51 shows the growth of tax revenues in East and West Pakistan in the period under study. An examination of these tables indicates that both the central and provincial budgets in Pakistan have grown at a fairly rapid rate because of rapidly rising development and non-development expenditures. The revenue budgets have also shown significant surpluses which have been utilized to finance the capital expenditures. Yet due to mounting development and non-development expenditures, the Governments have been forced to take increasing resort to inflationary financing. If adequate attempts had been made to tap all the tax potentialities of the country, the reliance on deficit financing could be reduced though not altogether eliminated because in a poor country, taxation cannot be pushed too far without a serious loss of private incentives to save and invest. Some of the outstanding deficiencies in Pakistan's tax structure are therefore worth noting.

First, the agricultural sector, which contributes about half of the national income, has not been adequately taxed. While incomes in this sector have increased over time with rising agricultural productivity and prices, revenue receipts from this sector have remained almost stagnant. So far, there are only two major sources of taxing the agricultural sector namely (a) land revenue which is a direct tax proportionate to the quality and productivity of land and (b) export taxes on agricultural products. Of these, land revenue rates have remained unchanged since the pre-war period and have continuously declined as a proportion of rising agricultural incomes. There is a pressing need for the revision of land revenue rates so as to make them consistent with rising incomes

in this sector. Moreover, land revenue is not an adequate basis for the assessment of incomes of big landowners. Under the present system, agricultural incomes are not covered by central income tax. The Taxation Enquiry Committee of 1960 had recommended the extension of central income tax to cover agricultural incomes but this recommendation was not accepted because no government in Pakistan was prepared to face the opposition of big landlords who have always exercised considerable political influence particularly in West Pakistan. Under the existing system, the big landlords are not adequately taxed while their counterparts in industry and services pay income and super taxes. It is worthwhile reconsidering the proposal of an agricultural income tax, as in a primarily agricultural country the agricultural sector must contribute adequately to the national exchequer. There is little doubt that a very large majority of farmers will come under the exemption limit of agricultural income tax but at least large agricultural incomes can be properly netted through this measure. Increased tax receipts from the agricultural sector can then be used for building up the rural infra-structure and development of agriculture through the public sector though in some countries effective taxation of agricultural sector<sup>has been</sup> used for financing industrial development also. This was true of Japan after 1870 under the Meiji rule<sup>2</sup>.

In the industrial sector, receipts from income and corporation taxes have lagged far behind the growth of value added in industry due to a large variety of tax concessions granted to industry. According to one estimate only 10 per cent of industrial profits in Pakistan have been collected in taxes<sup>3</sup>. In view of the

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2. Cf. R.M. Bird and O. Oldman ( Eds. ), Readings On Taxation in Developing Countries, ( Baltimore, 1964 ), PP 436-449.

3. Cf. G.F.Papanek, Pakistan's Development, Op.Cit. P. 193.

TABLE 48

Growth of Central Budgets (Million Rupees)

Particulars	1954-55	1957-58	1961-62	1964-65	1967-68
	<u>Revenue Budget</u>				
Receipts	1172.7	1525.0	2316.9	3301.0	4927.0
Expenditure	1172.6	1521.8	1986.8	2736.2	4042.0
Surplus or Deficit	0.1	3.2	330.0	564.8	885.0
	<u>Capital Budget</u>				
<u>Receipts</u>					
Internal Resources	653.0	1117.2	971.2	1426.8	2082.5
External Resources	42.3	194.7	1159.2	1260.2	2287.8
Use of Cash Balances	-	270.6	-	-	52.7
Total Receipts	695.3	1582.5	2130.4	2687.0	4423.0
<u>Expenditure</u>					
Development	561.0	1457.2	1996.4	2426.0	3960.8
Non-Development	103.3	125.3	96.9	254.5	412.2
Contingency Item	-	-	-	-	50.0
Total Expenditure	664.3	1582.5	2093.3	2680.5	4423.0
Cash Balance Improvement	31.0	-	37.1	6.5	-
Total Disbursements	695.3	1582.5	2130.4	2687.0	4423.0

Source: Government of Pakistan, Annual Budgets.

TABLE 49

Growth of East Pakistan Budgets (Million Rupees.)

Item	1954-55	1957-58	1961-62	1964-65	1967-68
<u>Revenue Budget</u>					
Receipts	244.2	314.1	624.7	1146.7	1380.7
Expenditure	284.7	276.3	499.1	1091.2	1430.4
Surplus or Deficit	-40.5	37.8	125.6	55.5	-49.7
<u>Capital Budget</u>					
Receipts	107.0	381.2	343.0	923.7	1894.0
Expenditure	72.2	327.3	291.7	964.2	1895.8
Cash Balance Utilization	-34.8	-53.9	-51.3	40.5	1.8

Source: East Pakistan Government Budgets.

TABLE 50

Growth of West Pakistan Budgets (Million Rupees)

Items	1954-55	1957-58	1961-62	1964-65	1967-68
<u>Revenue Budget</u>					
Receipts	475.2	610.7	1083.5	1713.0	1871.8
Expenditure	435.3	614.7	803.1	1488.4	1806.6
Surplus or Deficit	39.9	- 4.0	280.4	224.6	65.2
<u>Capital Budget</u>					
Receipts	279.1	448.7	656.7	923.7	1324.1
Expenditure	297.7	343.7	615.9	964.2	1505.1
Cash Balance Utilization	18.0	-105.0	-40.8	-57.9	181.0

Source: West Pakistan Government Budgets.

TABLE 51Growth of Tax Revenues in East and West Pakistan( Million Rupees )

Year	Central	East Pakistan	West Pakistan	Total
1955-56	1113	232	263	1608
1956-57	1022	234	344	1600
1957-58	1048	262	361	1671
1958-59	1390	410	523	2323
1959-60	1399	334	425	2158
1960-61	1572	366	501	2439
1961-62	1717	458	404	2579
1962-63	1681	566	702	2949
1963-64	1878	708	794	3380
1964-65	2404	720	796	3920
1965-66	2547	863	941	4351
1966-67	3272	974	988	5234
1967-68	3592	940	979	5511

Source: Computed from C.S.O., Pakistan Statistical Year Books.

incentives provided by protective tariffs, import licensing system and over-valued exchange rate, there is little justification for the continuation of tax concessions of different kind to industry. Industry's position with regard to taxes needs to be reviewed if additional tax revenues are to be raised.

Equally important is the revision of personal income tax. The exemption limit for personal income tax at Rupees 6000 is much above the average income in Pakistan due to which a large section of gainfully employed population escapes direct taxation. The Taxation Enquiry Committee of 1960 had also recommended that the exemption limit of income tax should be lowered so as to make it consistent with the average family incomes in Pakistan but this proposal was not implemented at that time. In our view, a revision of personal income tax is also desirable.

In the field of indirect taxes, excise duties have been an important revenue yielder but their receipts have been a declining proportion of the value of output. This is because, most excise duties in Pakistan are specific in nature and as prices have increased considerably over time, their impact has declined. It is essential that these are brought in line with the rising level of business and economic activity by changing them into ad valorem. The excise duties are an effective means of reaching the masses and are specially suited to the conditions of under-developed countries. On the one hand, they compare favourably with other taxes in terms of income-elasticity. This is due to the fact that in a developing economy, production of excisable commodities often increases relatively more than the non-excisable commodities and the relative importance of custom

duties also declines because of import substitution and import controls. Excise duties and sales taxes can, therefore, prove to be an effective way of taxing the common man.

In addition to raising the tax revenues by re-organising the tax structure, it would also be necessary to check the growth of non-development expenditures and to economize government expenditures. These steps are most likely to reduce the inflationary implications of deficit financing. Nevertheless, it would be too optimistic to hope that deficit financing can be altogether eliminated and if deficit financing operations continue, the monetary authorities will have to regulate monetary expansion on private account more effectively with a view to maintain price stability. In the following section, therefore, we examine the monetary policy of the State Bank of Pakistan during the period under review and suggest some improvements in it.

## 2. The Monetary Policy:

In a country where deficit financing operations are going on, the Central Bank must regulate bank credit to the private sector more effectively if it wants to avoid unpleasant experiences<sup>4</sup>. In Pakistan monetary expansion has been largely determined by the Government's deficit financing operations over which the State Bank did not have much control. Nevertheless there is evidence to suggest that the State Bank has not demonstrated adequate skills in acquiring control over monetary expansion on private account. It has failed to make an effective use of the monetary control measures available to it. In order to appraise the monetary measures taken by the State Bank

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4. Cf. Joachim Ahrensdoerf, "Central Bank Policies and Inflation", I.M.F Staff Papers, Vol. VII, N: 2, 1959.



of Pakistan during the period under study a historical digression seems to be necessary.

The State Bank was established in July 1948, almost a year after the creation of Pakistan. In its early years, the Bank was mostly concerned with the rehabilitation and expansion of credit facilities dislocated by the partition of India. Occasion for monetary control, therefore, did not arise for some time. In 1949, Pakistan decided not to devalue her currency while Britain and India did and this made the imports cheap. In the absence of import controls, this meant great pressure on the balance of payments and diversion of credit resources towards the import trade. In September 1950, therefore, the State Bank issued a directive to the scheduled banks for not financing the import trade too heavily and to make adequate provision for financing domestic investment and export trade. With the outbreak of the Korean War, the export trade automatically expanded and the balance of payments position improved significantly. In order to relieve stridency in the money market, the State Bank then supplemented the commercial banks' liquidity through open-market operations<sup>5</sup>. When the war was over, the balance of payments once again came under pressure. The State Bank then fixed a margin of 50 per cent on advances made by the scheduled banks to importers against the value of imported goods. Moreover, unsecured advances and those secured only by a guarantee were completely prohibited<sup>6</sup>. These conditions were, however, withdrawn in March 1953 because, with the imposition of import controls in 1952, the import trade automatically declined.

Prices increased at a sharp rate in the First Plan period but the State Bank continued to rely mainly on selective credit controls.

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5. Cf. S.A. Meenai, Money and Banking in Pakistan, ( Karachi, 1966 ) P. 161.

6. Cf. State Bank of Pakistan, Annual Report, 1951-52, PP. 19-20.

In January 1957, the scheduled banks were directed to limit their advances against imported manufactured goods, bullion, foodgrains and oilseeds to a maximum of 60 per cent of the value of such goods and also to restrict unsecured advances and those secured by guarantees to a maximum of Rupees 50,000 to an individual borrower<sup>7</sup>. In January 1958, a margin requirement of 50 per cent on advances by scheduled banks against shares of companies was also made<sup>8</sup>. All these restrictions were, however, withdrawn in November 1958 when, with the imposition of Martial Law, speculative imports and stock exchange activities were greatly curbed<sup>9</sup>.

The new regime paid greater attention to the maintenance of price stability and the State Bank was directed to take more rigorous measures of monetary control. In January 1959, for the first time, the Bank rate was raised from 3 to 4 per cent. As a result of this, the advances rate of commercial banks and other credit institutions increased but the market for gilt-edged securities and stocks remained almost unaffected<sup>10</sup>. Selective control on credit, however, still continued to remain the most popular weapon in the State Bank's armoury. With the relaxation in Martial Law regulations and a general movement towards a freer economy, speculative imports and stock exchange activities again revived. In January 1960, therefore, the scheduled banks were once again directed to limit their advances to 60 per cent against the shares of established companies and to 50 per cent against those of newly floated companies. In March the same

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7. Cf. State Bank of Pakistan, Report on Currency and Finance, 1956-57 P. 37.

8. Ibid, 1957-58 P. 36.

9. Ibid, 1958-59, PP.35-36

10. Cf. S.A. Meenai, Op.Cit. P. 165.

year, they were further directed to limit their advances against imported manufactured goods and cotton yarn to 60 per cent of their value. They were also required to limit their unsecured advances and those secured by guarantees to a maximum of Rupees 50,000 to an individual borrower.<sup>11</sup> However, in spite of these restrictions both the money supply and the price level continued to rise at a fast rate throughout the First Plan period.

In the Second Plan period, the price situation was fairly satisfactory but monetary expansion remained high especially in the last three years of the Plan. The pressure on prices was less because of a high rate of economic growth and liberal supplies of imports including those under the P.L. 480 programme. In the year 1962-63, monetary expansion reached a high level of Rupees 846 million. The rapid expansion in money supply and bank credit was the result of increased economic activity which gained momentum as the Second Plan entered its final phase. Of the total increase in money supply in this year, the private sector accounted for Rupees 364 million and the government sector for Rupees 165 million. In order to guard against the risk of serious inflation and to check the pace of credit expansion, the State Bank took more rigorous measures of monetary control. In July 1963, minimum reserve requirements for time deposits were raised from 2 per cent to 5 per cent while those for demand deposits were already 5 per cent. Moreover, the Bank introduced a quota system under which the scheduled banks could borrow from the State Bank at the prevailing Bank rate only up to 50 per cent of their average statutory reserves in each week of the previous quarter. The quota applied only to borrowings against government securities. For

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11. Cf. Government of Pakistan, Economic Survey, 1961-62 P. 122.

borrowings under the commercial bills re-discounting scheme, a limit was set at the maximum amount availed of by a particular bank in the year 1962-63. For borrowings in excess of the quota, the following rates were specified<sup>12</sup>.

- |   |                                    |
|---|------------------------------------|
| (1) Borrowings up to the limit of the quota   | At Bank Rate                       |
| (2) Borrowings in excess of (1) but limited to 100 per cent of the quota.                               | At 1/2 per cent above Bank Rate.   |
| (3) Borrowings in excess of the aggregate of (1) and (2) but limited to 200 per cent of the quota.      | At 1 per cent above Bank Rate.     |
| (4) Borrowings in excess of the aggregate of (1), (2) and (3) but limited to 200 per cent of the quota. | At 1 1/2 per cent above Bank Rate. |
| (5) Borrowings in excess of the aggregate of (1), (2), (3) and (4)                                      | At 2 per cent Above Bank Rate.     |

Despite these restrictions, monetary expansion in 1963-64 reached a record level of Rupees 1029 million. Of this, the government sector accounted for Rupees 627 million and the private sector for Rupees 418 million. As the demand for credit was high, scheduled banks' borrowings from the State Bank also increased substantially in this year. As money balances were not spent by the public immediately and remained accumulated for some time, the money-income ratio increased sharply to 0.192. Due to a high rate of economic growth of 8.3 per cent and a sharp rise in the money-income ratio coupled with a 23 per cent increase in real imports, the price level declined by 1 per cent in this year. Nevertheless, a high rate of monetary expansion was a cause of alarm for the State Bank. Consequently, in 1964-65, the Bank adopted more rigorous measures of monetary control. On the one hand, the quota for scheduled banks' borrowings from the Bank was

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12. Cf. Government of Pakistan, Economic Survey, 1963-64, Chapter 9.

reduced from 50 per cent of average statutory reserves maintained by them in the previous quarter to 25 per cent. Moreover, lending rates in excess of the quota were made more progressive. The following schedule of rates was laid down<sup>13</sup>.

- |   |                                    |
|---|------------------------------------|
| (1) Borrowings up to the limit of the quota.  | At Bank rate.                      |
| (2) Borrowings in excess of the quota but limited to 100 per cent of the quota.                         | At 1/2 per cent above Bank Rate.   |
| (3) Borrowings in excess of the aggregate of (1) and (2) but limited to 150 per cent of the quota.      | At 1 per cent above Bank Rate.     |
| (4) Borrowings in excess of the aggregate of (1), (2) and (3) but limited to 100 per cent of the quota. | At 1 1/2 per cent above Bank Rate. |
| (5) Borrowings in excess of (1), (2), (3) and (4).  | At 2 per cent above Bank Rate.     |

Moreover, the quota was extended to cover all borrowings of the scheduled banks from the State Bank whereas formerly it applied only to borrowings against government securities. In addition to the tightening of the quota system, the statutory reserve requirements for demand and time liabilities were raised from 5 to 7 1/2 per cent. The increase was to be implemented in two instalments namely 1 1/4 per cent on 1st April 1965 and the rest on 1st May 1965, the Bank rate was also further raised from 4 to 5 per cent<sup>14</sup>.

Despite these restrictions, the money supply increased by Rupees 682 million in 1964-65. The income velocity also increased from 5.20 to 5.29 in this year and the price index as shown by the national income deflator increased by 4 per cent. However, the tight

13. Cf. Government of Pakistan, Economic Survey, 1965-66, Chapter 9.

14. Ibid, P. 125.

money policy of the State Bank was severely criticised by the public. Moreover, the recessionary tendencies in Pakistan's economy in 1965-66, following the war with India, necessitated some relaxations in monetary policy. The credit controls imposed in 1964-65 were, therefore, relaxed in 1965-66. On the other hand, the quota system was withdrawn with effect from 16th August 1965 and differential rates of State Banks' lendings were abolished. Moreover, the statutory reserve requirements of the scheduled banks were reduced from 7 1/2 per cent to 6 1/4 per cent in August and to 5 per cent in September 1965. Lastly, the margin requirements for various types of banks advances were also substantially reduced<sup>15</sup>. Monetary expansion was the highest in this year namely, Rupees 1221 million due to heavy deficit financing but since income velocity declined significantly during the year, due to tightening of controls, the rise in prices was only 4.5 per cent.

In the following year, the G.N.P deflator showed a sharp rise of 12 per cent due to a rapid increase in income velocity, significant monetary expansion and crop failures. The State Bank then adopted a restrictive monetary policy. The margin requirements on certain types of bank credit lowered in September 1965 were again raised to their former level. The scheduled banks were also required not to extend credit facilities for financing hire purchase and instalment credit operations except with respect to agricultural and industrial machinery. In January 1967, the statutory reserve requirement for scheduled banks were raised from 5 per cent to 6 1/4 per cent<sup>16</sup>. In September 1967, the liquidity ratio was also,

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15. Ibid, P. 126.

16. Cf. Government of Pakistan, Economic Survey, 1967-68, Chapter IV P. 61.

for the first time, raised from 20 to 25 per cent. In January 1968, however, the reserve requirements for demand and time liabilities were lowered back to 5 per cent. No other credit measures were taken in 1967-68.

A review of the monetary measures taken by the State Bank of Pakistan during the period under study indicates that although the Bank has tried to regulate the money supply in the interest of price stability, it has not acquired much control over it partly due to the Government's deficit financing operations and partly to the fact that it has not used the instruments of monetary policy efficiently. The Bank must have exercised more rigorous monetary control in those years when income velocity was rising so as to avoid undue pressure on prices. The years 1956-57, 1959-60 and 1966-67 are especially noteworthy in this context. The income velocity increased sharply in these years but monetary expansion also turned out to be fairly high particularly in the private sector. The Bank relied most of the time only on selective credit control measures and rarely used other instruments of monetary control. There was considerable pressure on prices in the First Plan period but the Bank concentrated mainly on the regulation of bank advances to importers by fixing the margin requirements. In January 1959, however, for the first time, the Bank rate was raised from 3 to 4 per cent. On two more occasions, the Bank rate was used as an instrument of monetary policy, namely in 1963 when progressive rates were introduced under the quota system and in 1965 when the Bank rate was further raised to 5 per cent. But with a high demand for credit in the economy, these changes were not successful in curtailing the scheduled banks' borrowings from the State Bank which, in spite of

increased bank rate continued to rise sharply during the period under study. In order to be effective, very high marginal rates were required but these were undesirable for the reason that a change in bank rate is a barometer of general business conditions and any drastic rise in it would have severely hampered the private sector activities to the detriment of general economic development.

Changes in reserve requirements also failed to achieve their objective because the scheduled banks were always able to supplement their reserves by borrowing from the State Bank. A more effective way of regulating the scheduled banks' liquidity and thereby credit would have been to make necessary changes in their over-all liquidity ratio. The scheduled banks in Pakistan are required by law to maintain a minimum liquidity ratio of about 20 to 25 per cent of their time and demand deposits. Liquidity is defined to include gold and cash in tills, balances with the State Bank of Pakistan and unencumbered approved securities. Approved securities are those which the State Bank is willing to accept as collateral for its advances. The liquidity ratio was used as an instrument of monetary control only once in September 1967 when the required ratio was raised from 20 to 25 per cent. By regulating the scheduled banks' liquidity ratio, the Bank could simultaneously manipulate their holdings of cash, reserves, Government securities and advances more effectively. Thus what the changes in Bank rate and reserve requirements could not achieve individually can be more effectively achieved by one single operation.

The changes in liquidity ratio should be combined with open-market operations. Open-market operations have been rarely used by the Bank for the reason that the market for government



securities is currently very narrow. Of the total central and provincial Government debt in Pakistan over 90 per cent is held by the banking system. The yields on Government securities are rather low and have not increased much over the period under study. Considering the pace of inflation, the real rate of interest on Government securities is too unattractive for the general public and potential buyers. However, the commercial banks purchase these securities in order to maintain the required liquidity ratio. If a rise in the liquidity ratio is combined with the open-market sale of Government securities, it can prove to be more effective in checking the flow of bank credit to the private sector. On the contrary, a lowering of liquidity ratio together with the open-market purchase of Government securities by the State Bank can substantially increase the commercial banks' resources for advancing credit to the private sector and making investment in private securities. Moreover, in order to make the Government securities more attractive to the buying public, yields on them should be increased. An effective way to broaden the securities market would be to set prices on them at which the Bank would buy and sell unlimited amounts of Government securities. The State Bank can then raise or lower the buying and selling prices in a way to encourage purchases or sales by the public. If yields become more attractive, the commercial banks may also choose to hold Government securities in quantities greater than needed to fulfil their liquidity requirements in order to earn the high yields. Strong control over the quantity of credit and money would then be available to the State Bank through changing security prices in addition to other tools of monetary control especially changes in the liquidity ratio<sup>17</sup>.

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17. Cf. R.C.Porter, "Narrow Securities Markets and Monetary Policy: Lessons from Pakistan", Economic Development and Cultural Change, October, 1965.

By using the instruments of monetary control more effectively and taking appropriate action when necessary, the State Bank can acquire greater control over the price situation. If the fiscal control of the economy is also made more effective, smooth economic development would be possible. In the following chapters we shall consider some more policy variables influencing the price situation in Pakistan and these include the agricultural and commercial policies. The following chapter is devoted to an examination of the agricultural policy in Pakistan and its implications for the price situation.

## CHAPTER VI

### AGRICULTURAL POLICY AND FOOD DEFICITS

#### 1. AGRICULTURAL DEVELOPMENT AND POLICY:

The developing countries often lay too much emphasis on industrialization and in their attempt to industrial<sup>u</sup>ize rapidly tend to forget their real resource potentials. Agricultural development is often given secondary place in economic development programmes and rapid development of other sectors at the expense of agriculture creates serious imbalances in the economy. In the face of rising money incomes and the emerging industrial sector, severe pressure is exerted on the agricultural sector for food and raw material supplies. Due to the lagging agricultural sector, supplies of agricultural products become inadequate and their prices rise at a fast rate causing general inflationary pressures in the economy. Since industrial development programmes occupy a prestigious position, justice cannot be done to the agricultural sector. The neglect of agricultural sector in Pakistan has given rise to serious food shortages which have been the principal source of inflationary pressures in the economy. Food being an important wage-good, its shortage also has had serious welfare implications.

The areas comprising Pakistan and more particularly West Pakistan were considered to be the granary of undivided India. Thus, Pakistan inherited a primarily agricultural economy with only 10 per cent of the aggregate manufacturing capacity of undivided India. Little manufacturing capacity coupled with fairly large supplies of domestic raw materials and a wide market for consumption goods provided considerable private incentive for industrial development. Guided by the import substitution motive, the Government provided great concessions

to those who took initiative in setting up the industrial capacity. On the one hand, heavy protection was provided to domestic industry through high protective tariffs. On the other, liberal tax concessions in the form of tax holidays and depreciation allowances were allowed to the emerging industries. Moreover, the foreign exchange earned by the agricultural sector through the export of primary products was liberally allocated to industries for the import of capital goods and raw materials. The seriously overvalued exchange rate, following Pakistan's decision not to devalue her currency in September 1949, meant a great subsidy to industry and a net transfer of resources from the agricultural to the industrial sector took place. Consequently, profit margins and re-investment rates remained high in the industrial sector and this sector maintained an average annual compound rate of growth of about 24 per cent during the period 1950-55, though from a very low base. An important feature of industrial development was the establishment of cotton textile industry which in 1954 accounted for nearly 45 per cent of the value added in large-scale manufacturing and some varieties of textiles also began to be exported.

In sharp contrast to the rapidly expanding industrial production, the agricultural output tended to stagnate in this period while the output of food crops actually declined as there was some shift towards the production of cash crops. The stagnation of agricultural sector was the outcome of Government's development policy and deliberate turning of the terms of trade against agriculture and in favour of industry. From 1953 onwards a policy of food control and rationing was being pursued in Pakistan under which the surplus areas in major foodgrains were required to sell all their

surplus products only to the Government at fixed prices which were much lower than what they could fetch in the open market. In addition, heavy export duties existed on jute, cotton and tea which yielded nearly 10 to 15 per cent of all Government revenues. These tended to lower the rupee price of commercial crops to the farmers. Both these factors tended to depress farm incentives with respect to food as well as non-food crops.

It was a part of the Government's saving strategy in the 1950's to deliberately turn the terms of trade against agriculture and in favour of industry for the purpose of transferring income to the high-saving manufacturing sector. Moreover, import controls imposed in 1952 restricted the import of manufactured goods and raised their prices. The import controls together with food rationing and price control have been instrumental in effecting a transfer of income from the agricultural to the industrial sector. On the one hand, the over-valued currency, export duties on agricultural products and subsidization of food prices in the urban areas through imports and compulsory procurement from the agricultural sector kept down the prices received by the farmers below world prices. On the other hand, the prices that the agricultural sector had to pay for its imports from the non-agricultural sector were much higher than the world prices due to restricted imports and high-cost of domestic industries. An estimate of this resource transfer made by K.B. Griffin puts it as high as 15 per cent of the agricultural income in 1964-65<sup>1</sup>. But Griffin has only measured the difference between the current price exports from the agricultural sector and current price imports made.

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1. Cf. K.B. Griffin, "Financing Development Plans in Pakistan", Pakistan Development Review, Winter, 1965

by this sector at domestic prices. This does not reflect the terms of trade loss which has been measured by Stephen R. Lewis<sup>2</sup>. The terms of trade indices computed by him for the two sectors of the economy which represent the net barter terms of trade for each sector, that is the wholesale prices of goods that the sector sells relative to the wholesale prices of the goods that it buys. These are given in Table 52. The indices indicate that the net barter terms of trade of the manufacturing sector improved and those of the agricultural sector deteriorated from 1951-52 to about the middle of 1960's. The movements in East Pakistan were much sharper than the movements in West Pakistan but in both cases, the movements are quite distinct.

Lewis has also computed the implicit exchange rates for agriculture and industry<sup>3</sup>. An implicit exchange rate is the ratio between the domestic wholesale price in rupees and the international ( c.i.f or f.o.b ) price of the same item in dollars. Table 53 gives the implicit exchange rates for the two sectors. The averages represent the domestic values of \$ 1.00 worth of the commodity or bundle of commodities sold and purchased by these sectors. This table points out the difference between the terms of trade that agriculture and manufacturing maintained domestically and the terms of trade that they could maintain if they had traded in international markets without the distortions introduced by the restrictive trade policies. It is evident from this table that even in the mid-1960's, the agricultural sector received about Rupees 5.00 for agricultural goods worth \$ 1.00 but it paid over Rupees 8.00 for manufactured goods worth \$ 1.00. Thus

2. Cf. Stephen R. Lewis, Economic Policy and Industrial Growth in Pakistan, (London, 1969), Table 12, P. 60.

3. Cf. Stephen R. Lewis and S.M. Hussain, Relative Price Changes and Industrialization in Pakistan, 1951-64 (P.I.D.E Monograph, Karachi, 1967) and also Stephen R. Lewis, "Effects of Trade Policy on Domestic Relative Prices: Pakistan 1951-64" The American Economic Review (March 1968).

the restrictive trade policies led to a serious distortion in the allocation of resources between the two main sectors of the economy. The unfavourable terms of trade between the two sectors hindered the commercialization of agriculture and retarded investment in agricultural improvements. It tended to reduce the agricultural incomes and thereby savings in the agricultural sector.

It is often thought that the farmers in under-developed countries are not very responsive to price changes but this was not true of Pakistani farmers in the 1950's who reacted sharply to the lack of price incentives and did not exert themselves fully to expand their output. The area under principal agricultural crops which had substantially increased up to 1953-54 showed little increase since then. In a country where yields per acre are low and can be increased only in the long-run, the increase in acreage is an important way of expanding the agricultural output but this could not be done due to inadequate incentives. Empirical studies about farmer response to price changes in Pakistan have revealed a fairly high price-elasticity of supply. W.P.Falcon has, computed the price-elasticity of acreage for cotton in West Pakistan to be 0.4 which equals that found for the United States<sup>4</sup>. In an earlier study of undivided Punjab region, Raj Krishna also found high elasticities of 0.6 and 0.7 for rice and cotton respectively and 0.2 to 0.4 for other crops except wheat and bajra for which the elasticities were only 0.1<sup>5</sup>.

Out-put in the agricultural sector continued to remain depressing in the First Plan period partly due to unfavourable weather

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4. Cf. W.P.Falcon, "Farmer Response to Price in a Subsistence Economy: The Case of West Pakistan", American Economic Review, Papers and Proceedings, May 1964, PP. 580-591.

5. Cf. R. Krishna, "Farm Supply Response in India-Pakistan: Case Study of the Punjab Region", Economic Journal; September 1963 PP. 477-487.

TABLE 52

Domestic Inter-Sectoral Terms of Trade for East and West Pakistan( 3 Year Moving Averages, 1951-52 to 1963-64 ).

Year	West Pakistan		East Pakistan	
	Manufacturing Sector	Agricultural Sector	Manufacturing Sector	Agricultural Sector
1951-54	108.62	97.39	126.86	77.09
1952-55	112.22	91.14	138.55	65.32
1953-56	116.42	87.36	144.81	62.83
1954-57	112.00	91.41	128.54	78.34
1955-58	107.77	96.03	108.67	90.11
1956-59	104.52	98.76	97.28	97.19
1957-60	102.60	99.43	99.65	94.93
1958-61	98.05	103.13	101.67	100.65
1959-62	95.32	106.39	105.53	102.14
1960-63	94.75	108.28	106.21	103.01
1961-64	96.06	107.84	104.36	100.46

Notes: For the manufacturing sector's terms of trade: The weights for manufacturing prices are the values added in each industry in 1959/60 and the weights for agricultural prices are estimated purchases of agricultural goods by the non-agricultural sector in 1959/60.

For the Agricultural sector's terms of trade: The weights for agriculture prices are the gross output of each commodity in 1959/60, and the weights for manufactured goods are estimated purchases of manufactures by the agricultural sector in 1959/60.

Source, Stephen R. Lewis, Economic Policy and Industrial Growth in Pakistan, Table 12. p. 60.



TABLE 53

Implicit Exchange Rates for Agricultural and Manufactured  
Goods, East and West Pakistan (three-year averages)

## EAST PAKISTAN

	Manufactured Goods		Agricultural Goods	
	Gross Output	Purchased by Agriculture	Marketings	Purchased by Manufacturing
1951-54	6.15	9.07	2.87	3.32
1952-55	6.62	9.74	2.73	3.01
1953-56	6.88	10.17	2.86	2.97
1954-57	7.00	9.81	3.70	3.77
1955-58	7.20	9.83	4.46	4.57
1956-59	7.14	9.46	4.85	5.01
1957-60	7.20	9.07	4.65	4.95
1958-61	7.21	8.56	4.75	5.10
1959-62	7.13	8.42	4.83	5.17
1960-63	6.85	8.29	4.87	5.09
1961-64	6.63	8.15	4.77	4.93

## WEST PAKISTAN

	Manufactured Goods			Agricultural Goods		Official Exchange Rate
	Gross Output	Purchased by Agriculture	Marketings	Purchased by Manufacturing		
1951-54	7.07	8.39	3.81	4.13		3.31
1952-55	7.63	8.94	3.81	4.15		3.31
1953-56	7.84	9.00	3.76	4.06		3.78
1954-57	7.66	8.51	3.94	4.19		4.27
1955-58	7.90	8.56	4.33	4.57		4.75
1956-59	7.96	8.57	4.73	5.06		4.75
1957-60	7.95	8.68	4.85	5.30		4.75
1958-61	7.73	8.59	5.06	5.60		4.75
1959-62	7.68	8.61	5.19	5.70		4.75
1960-63	7.53	8.41	5.40	5.79		4.75
1961-64	7.39	8.33	5.35	5.69		4.75

Source: Stephen R. Lewis, Economic Policy and Industrial Growth in Pakistan, Table 19, p. 91.

conditions and partly to inadequate implementation of development programmes in this sector. Government's policy towards agriculture remained as it was in the pre-Plan period namely food control and high export taxes on agricultural products continued. The sectoral distribution of development expenditures in the Plan also reflected serious neglect of agricultural development. Although the Plan claimed to have given top priority to the development of agriculture, only 23 per cent of aggregate Plan outlays were assigned to irrigation and agriculture taken together while industry and mining claimed 28 per cent. How this disparity between the Plan objectives and sectoral allocation of development funds can be reconciled remains unexplained. For a country where agriculture contributes about half of the national income, these allocations were very disappointing. What is more, there were significant shortfalls in actual programmes in the agricultural sector and only 17 per cent of the actual development outlays of the Plan went into agriculture while industry and mining received 31 per cent. Consequently, the growth rates in industry and agriculture continued to be strikingly unbalanced. Although industrial development also suffered a lot in this period on account of foreign exchange difficulties and consequently shortage of capital goods and raw materials and considerable idle capacity was reported in this sector, industry continued to remain by far the leading sector in the country. While agriculture maintained a poor rate of growth of 1.4 per cent per annum on an average, industry maintained a compound rate of growth of about 10 per cent per annum.

In the Second Plan period, however, performance of the agricultural sector was much better. The average rate of growth maintained by this sector and shared almost equally by both parts of the country was about 3.5 per cent per annum as against 1.4 per cent

in the previous Plan. In spite of heavy damage caused by floods and cyclones in East Pakistan and drought in West Pakistan in some years of the Plan, crop production maintained an upward trend. The output of foodgrains increased by 3.6 million tons as against the Plan target of 2.7 million tons. In the case of cash crops, however, significant shortfalls were reported especially in case of jute, tea and tobacco. An over-all high rate of growth maintained <sup>by</sup> the agricultural sector in this Plan can be explained in terms of such changes as greater use of modern inputs and expansion in water supply especially through private tube-wells. On the basis of a quantitative analysis, it has been reported that private tube-wells accounted for about 9 per cent of the increase in irrigation water supplies in West Pakistan in the Second Plan period and that almost one-fourth of the total 27 per cent increase in the value of crop output in this period can be attributed to the increase in private tube-wells<sup>6</sup>. Government's policy towards agriculture had, by this time, taken a more favourable turn. The food control and rationing had been abolished in 1960 and support prices for major foodgrains were introduced instead, with a view to protecting the farm incentives. The Plan allocations to agriculture were also made more favourable as compared with the previous Plan. For the first time, the share of agriculture and irrigation in the aggregate Plan outlays was kept close to industry and mining namely 24 and 26 per cent respectively. Although the public sector development programmes in agriculture met with significant shortfalls, they were more than made up by the excess of private investment over the Plan allocations.

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6. Cf. W.P. Falcon and C.H. Gotsch, "Lessons in Agricultural Development-Pakistan" in G.F. Papanek (Ed.), Development Policy, Theory and Practice, (Harvard University Press, 1968), P.278.

However, acute sectoral imbalance continued in this Plan as well. With a relative improvement in the foreign exchange position, investment and growth in the industrial sector once again accelerated. Private investment in the industrial sector more than doubled in this period and the average annual compound rate of growth increased to 15 per cent. Most of the complex industries like engineering and chemicals grew more rapidly in this period.

One of the important targets of the Third Plan was to achieve food self-sufficiency by 1970. In view of this objective, a target of 5 per cent annual growth rate was fixed for the agricultural sector. In the public sector allocations, for the first time, equal importance was given to agriculture and industry. In the private sector however, Plan allocations to agriculture were almost half of industry. In practice, the performance of the agricultural sector in the first two years of the Plan was deplorable due to unfavourable weather conditions both in East and West Pakistan. The output of foodgrains declined by about 7.6 per cent in these years from its 1964-65 level and the average rate of growth in the agricultural sector was only 1.4 per cent. This gave rise to a serious food shortage in the country which was aggravated by reduced availabilities under the P.L. 480 programme. The revised version of the Third Plan gave top priority to those programmes which had a direct bearing on food output. Nevertheless, the food shortage continued until 1967-68 in which year the crops were exceptionally good and the output of major foodgrains went up by 22 per cent. As a result of good crops in this year, the average rate of growth in the agricultural sector turned out to be 3 per cent per annum in the first three years of the Plan.

Growth in the industrial sector also suffered seriously in this period due to foreign exchange difficulties and cut-back in foreign aid. The Plan had laid considerable emphasis on the development of industrial sector and more particularly on the establishment of a heavy industrial complex. About 13 per cent of the public sector and 42 per cent of private sector development outlays were assigned to this sector. But in the first two years of the Plan only 20.5 per cent of the proposed public sector investment and 28.2 per cent of private sector investment could be realized. In the third year of the Plan, however, industrial investment recovered substantially and the average annual compound rate of growth maintained by the industrial sector in these three years turned out to be 9 per cent, that is three times that of agriculture.

## 2. The Demand for Food and Food Deficits:

We have seen the progress of agriculture in Pakistan and the importance given to it in the process of economic development. The slow rate of growth in the agricultural sector, together with a high rate of population growth and rising per capita incomes, were bound to create serious food deficits and excess demand conditions in the market for agricultural products. Studies undertaken by the F.A.O. testify that the per capita consumption of staple grains and root crops tends to rise rapidly in a developing economy<sup>7</sup>. Unless the agricultural sector is able to meet the rising demand for food, excess demand for food is most likely to appear in the process of economic development. Agriculture's role of providing more food and raw materials to the non-agricultural sectors can be fulfilled only if this sector has enough supplies of capital and modern inputs and

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7. Cf. United Nations, F.A.O., The State Of Food And Agriculture, 1965 P. 71.

if adequate attempts are made to transform the production techniques so as to raise yields per acre. This has <sup>not</sup> been satisfactorily done in Pakistan where industrialization has demanded greater attention and a larger portion of development resources. Consequently, the development process has been characterized by serious food shortages which have not been fully overcome even by imports so that considerable pressure has been exerted on food prices which has contributed to the general inflationary pressures in the economy.

Until about 1950, Pakistan had a comfortable food supply. In normal years, the country had enough major foodgrains for domestic consumption together with a small exportable surplus of about three to five hundred thousand tons. In the 1950's, however, the food output maintained an average rate of growth of only 1 per cent per annum whereas the rate of population growth was over 2 per cent per annum and there was some increase in per capita incomes as well. The domestic output, therefore fell significantly short of demand and food imports began to feature prominently in total imports. During 1950-55 about 1.6 million tons of foodgrains were imported into Pakistan and as the P.L. 480 food imports began only from 1954, most of these imports had to be financed from the country's own meagre foreign exchange resources. Nevertheless, the food prices maintained an upward trend indicating an excess demand for food in the economy. The nutritional standards also deteriorated in the absence of adequate food supplies. In view of the deteriorating food position in the country and to subsidize the cost of living of urban industrial workers, price and distribution controls on major foodgrains were imposed in 1953.

The food position worsened in the First Plan period as the demand for food continued to rise with an annual population growth rate of about 1.8 per cent and some increase in per capita income while the

rate of growth in the agricultural sector was deplorably low. Food imports aggregated 5 million tons in the Plan period (including those under the P.L. 480 programme) and these constituted about 8 per cent of the domestic production of foodgrains. Yet, both the controlled and free market prices of rice in East Pakistan and of wheat in West Pakistan continued to rise throughout the Plan period.

In the Second Plan period, however, the output of foodgrains increased on an average by about 4 per cent per annum. But with a population growth rate of 2.6 per cent per annum and a rise in per capita real income of about 3.5 per cent per annum, the food deficit continued. The food imports aggregated 8 million tons in this period and only with heavy food imports it was possible to stabilize the prices of major foodgrains to a considerable extent and also to lift the price and distribution controls on foodgrains in 1960.

In the Third Plan again the country faced a serious food shortage both on account of poor crops and reduced availabilities under the P.L. 480 programme. The output of major foodgrains declined significantly in the first two years of the Plan though in the third year, there was a substantial increase. However, with a population growth rate of 2.7 per cent per annum and a rise in the per capita real income of about the same magnitude, the demand for food increased at a fast rate. The food imports aggregated 6 million tons in the first three years of the Plan and a major portion of them had to be financed from the country's own foreign exchange resources. Still the food prices rose at a significantly fast rate indicating an excess demand for food in the economy.

In order to see to what extent, the per capita foodgrain consumption in Pakistan has been influenced by the rising per capita

real income, the income-elasticity of foodgrain consumption was computed and was found to be 0.59. The computations were based on the data given in Tables 54 and 55 and the computed result is as follows:

$$\text{Log } C_p = - 0.33755 + 0.58874 \text{ Log } Y_p$$

$$(0.20704)$$

$$R = 0.651 \quad R^2 = 0.424$$

where,

$C_p$  = the per capita consumption of foodgrains in real terms.

$Y_p$  = the per capita real income.

It must, however, be mentioned that the actual consumption of foodgrains in Pakistan during the period under study does not fully represent the demand because it was restricted by availabilities. The fact that food prices moved up significantly throughout the period under study indicates that there has been an excess demand for food in the economy. Nevertheless, in the absence of any other possible measure, the elasticity computed above can be taken as an approximation of the income-elasticity of the demand for foodgrains in Pakistan. By using the rate of population growth and the income-elasticity computed above, an estimate can also be made of the warranted increase in the output of foodgrains. Table 56 gives this estimate. Column 2 of the table shows the warranted growth of foodgrain output which equals:

$$G_f = P + \eta Y_p$$

where  $G_f$  is the warranted increase in food output in per cent,  $P$  the population growth rate,  $\eta$  the income-elasticity of the demand for food and  $Y_p$  the rate of growth in per capita real income. The population elasticity of the demand for food was thus assumed to be unity and the income-elasticity 0.6. Table 56 indicates that in most



of the years under study, the rise in domestic output of foodgrains was much less than warranted in view of the rising population and per capita real incomes in the economy, thus creating excess demand conditions in the market for foodgrains. Although a large part of this excess demand was met from imports (including those under the P.L. 480 programme) and releases from government foodgrain stocks, the food prices maintained a constant upward trend during the period under study reflecting an unsatiated demand for food in the economy. The pressure on food prices was a major factor determining the cost of living in the country and was greatly responsible for the inflationary pressures experienced in the course of economic development.

Let us now examine the food position in both wings of the country in more detail.

### 3. The Food Position in East Pakistan:

In East Pakistan, agriculture is the major source of income, wage goods, export earnings and industrial raw material but the agricultural sector which dominates the East Pakistan economy is unduly dependent on weather conditions and co-operation of nature. Production of major crops in that part is very greatly determined by weather conditions and there are 10 to 15 per cent variations in it according to whether or not the weather is favourable. The food position in East Pakistan is largely determined by the changes in crop conditions.

In 1955-56, there was a serious shortage of rice in East Pakistan due to unfavourable weather conditions and poor crops. The net availability of rice declined from 7.6 million tons in 1954-55 to 6.5 million tons in 1955-56 and the average price per maund increased sharply from Rupees 13.25 to Rupees 20.94. Substantial foreign exchange

which was needed for financing the development imports had to be diverted to pay for foodgrain imports. West Pakistan also became a food deficit area in the 1950's and foreign exchange expenditure on foodgrains became the single most important drain on Pakistan's balance of payments after 1956. The value of foodgrains imports in the three years 1956 to 1958 exceeded the value of total capital goods imports into the country. The availability of rice in East Pakistan increased significantly after 1955-56 and remained fairly large over the rest of the First Plan period but the average price of rice per maund ruled over Rupees 30 and remained more or less unchanged in the following four years of the Plan. This is because with a rise in population, the demand for foodgrains in that wing increased at a faster rate than either local production or imports. Pressure on food prices was, therefore, inevitable. Table 57 gives the net availability of wheat and rice in East Pakistan and their prices during the First Plan period.

The food position in East Pakistan remained comfortable in 1960-61 despite food decontrol and the provincial Government maintained large stocks of foodgrains to meet emergencies. Total production of rice during 1960-61 amounted to 10.5 million tons of which East Pakistan produced 9.5 million tons. Import of rice during the calendar year 1960 also aggregated over three hundred thousand tons valued at Rupees 275 million. Consequently despite decontrol, the rice prices in East Pakistan during the year 1960-61 remained below the level of the preceding year. This was due to better supply position following two successive bumper crops. The record 1959-60 rice crop of 9.5 million tons was surpassed in 1960-61 by 11.3 per cent and created a new record of 10.5 million tons. The rise in rice

production was due to favourable weather conditions coupled with use of better seed and fertilizers. The yearly average retail price of coarse rice dropped to Rupees 24.5 per maund in 1960-61 compared to Rupees 26.6 in the previous year.

The acreage under rice declined in 1961-62 due to increased acreage under jute which competes for land with rice crop yet there was another record crop of 10.6 million tons and rice prices remained stable. The following year, area under rice crop increased but production could not keep pace with the rise in acreage because of severe floods and attack of pests and crop diseases in East Pakistan. The production of rice, therefore, declined to 9.9 million tons. Import of foodgrains into the province, however, reached a record level of 1.4 million tons and the per capita availability of food-grains reached a high level of 352 lbs during the year. The average retail price of coarse rice ruled around Rupees 27 per maund.

The production of rice which suffered a set-back in 1962-63 set an all time record in 1963-64 when it increased to 11.6 million tons. The new production level exceeded the Second Plan target of 10.2 million tons by 14.5 per cent. Rice prices, therefore, ruled lower in East Pakistan during 1964. The provincial average prices of coarse varieties of rice remained within the range of Rupees 21 to Rupees 25 per maund during 1964 compared to the range of Rupees 22 to 30 per maund in 1963. Imports of foodgrains into the province were also at a high level in this year and the per capita availability of foodgrains including rice and wheat reached an all time record of 374 lbs during 1963-64.

In 1964-65, the acreage of rice in East Pakistan increased by 1.9 per cent over the previous year but production showed a decline of 0.9 per cent. The decline

in production was due to damages caused to crops by floods and low yields in some districts. Imports of rice during 1964-65 were also substantially lower than in the previous year. Rice prices, therefore, moved up further in this year. The average retail price of coarse rice in the province was around Rupees 25.10 per maund. Imports of rice during 1964-65 were 0.58 lakh tons against 1.43 lakh tons in 1963-64 and 2.36 lakh tons in 1962-63. The entire quantity was supplied to East Pakistan. While rice prices declined in 1964, in the first three months of 1965, the prices showed an upward trend and the provincial average rose from Rupees 22 at the beginning of January 1965 to Rupees 25 at the end of March 1965.

Two successive bad harvests in both wings of the country due to climatic factors, put a serious strain on food supplies in the country in 1965-66 and 1966-67. The situation was aggravated by a decline in imports from the United States under the P.L. 480 programme. Import of food-grains from Pakistan's own resources had to be increased and imports into East Pakistan were also raised but due to irregular and slow supply of foodgrains in the province, the provincial Government had to restrict the issue of wheat and rice from its stocks in order to maintain adequate resources for any future emergency. As a result, the per capita availability of foodgrains in the province declined sharply and the average retail prices of all varieties of rice shot up during the years 1965-66 and 1966-67. The retail price of coarse rice increased sharply from Rupees 25.1 per maund in 1964-65 to Rupees 29.1 per maund in 1965-66 and to Rupees 38.7 in 1966-67.

The food situation, which was difficult in 1966-67 showed a marked improvement in 1967-68. Domestic production of foodgrains in both East and West Pakistan showed considerable increases. The

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TABLE 54

Total Availability of Foodgrains, 1955-68 (Million Tons)

Year	Domestic Production	Allowance for Seed, Animal Feed, Wastage etc. 10%	Imports	Exports	Changes in Govt. Stocks	Total Avail- ability.
1955-56	11.7	1.2	0.2	0.1	-0.5	11.1
1956-57	13.8	1.4	1.3	-	-0.2	13.9
1957-58	13.0	1.3	1.4	-	+0.1	13.0
1958-59	12.9	1.3	0.7	-	+0.1	12.2
1959-60	14.5	1.5	1.3	0.1	+0.1	14.1
1960-61	15.4	1.5	1.7	0.1	-	15.5
1961-62	15.8	1.6	1.1	0.1	-	15.2
1962-63	15.3	1.5	1.9	0.2	-0.1	15.6
1963-64	17.0	1.7	1.7	0.1	+0.2	16.7
1964-65	17.6	1.8	1.8	0.2	-	17.4
1965-66	16.8	1.7	1.3	0.1	-	16.3
1966-67	16.4	1.6	2.4	0.2	-0.1	17.1
1967-68	19.9	2.0	2.0	-	-	19.9

Source: Computed from Government of Pakistan, Central Statistical Office, Monthly Statistical Bulletins and Economic Surveys.

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TABLE 55

Per Capita Consumption of Foodgrains, 1955-68

Year	Total Consumption (Million Tons)	Population (Millions)	Per Capita Consumption (Tons)	Per Capita Real Income (Rupees).
1955-56	11.1	90.3	0.12	308
1956-57	13.9	92.4	0.15	319
1957-58	13.0	94.5	0.14	315
1958-59	12.2	96.7	0.13	312
1959-60	14.1	98.9	0.14	318
1960-61	15.5	101.5	0.15	326
1961-62	15.2	104.1	0.14	337
1962-63	15.6	106.8	0.14	340
1963-64	16.7	109.6	0.15	359
1964-65	17.4	112.4	0.16	365
1965-66	16.3	115.4	0.14	372
1966-67	17.1	118.6	0.16	381
1967-68	19.9	121.8	0.16	397

Source: Computed from Table 54.

TABLE 56Warranted and Actual Growth of Foodgrain output

Year	Warranted Growth of Foodgrain Output Per cent	Actual Growth of Foodgrain Output Percent	Excess of 1 over 2 in per cent of Foodgrain Output
1955-56	0.8	- 7.9	8.7
1956-57	4.5	18.5	-14.0
1957-58	1.5	- 6.2	7.7
1958-59	1.7	- 2.2	3.9
1959-60	3.4	13.6	-10.2
1960-61	4.2	7.0	- 2.8
1961-62	4.6	1.9	2.7
1962-63	2.1	- 3.7	5.8
1963-64	6.0	12.4	- 6.4
1964-65	3.6	2.5	1.1
1965-66	3.8	- 3.3	7.1
1966-67	4.1	- 4.3	8.4
1967-68	5.2	22.3	-17.1

Source: Computed from Table 1 and 3.

TABLE 57NET AVAILABILITY AND PRICE OF WHEAT AND RICE IN EAST PAKISTAN

Year	Wheat, Net Availability ( 000 Tons )	Price Rs. Per Maund	Rice, Net Availability ( 000 Tons )	Price Rs. Per Maund
1954-55	38	12.56	7591	13.25
1955-56	47	19.19	6465	20.94
1956-57	90	19.31	8720	30.83
1957-58	108	19.38	8188	28.58
1958-59	88	16.38	7209	30.50
1959-60	200	17.56	8913	32.02

Source: P.I.D.E, A Measure of Inflation in Pakistan, Tables 1 and 2, Appendix B.



production of rice was almost 15 per cent higher than in 1966-67. Import of foodgrains into the province including wheat supplies under the P.L. 480 programme increased sharply. Per capita availability of total foodgrains, therefore, increased to 348 lbs during the year as compared with 337 in the previous year. The average retail prices of rice which had increased sharply in the previous year also came down to more normal levels.

The rise in retail prices of rice in East Pakistan over the period under study can be explained in terms of the per capita availability and deteriorating food situation in the province or in terms of rising money supply. Studies indicate that the former has dominated as a factor influencing the price of rice. On the basis of linear regression analysis, covering the data for the period 1959-60 to 1967-68 and taking the average retail price of coarse rice in rupees per maund as a dependent function of annual per capita availability of total foodgrains and estimated provincial money supply, Rabbani and Repetto have found that the annual retail price of coarse rice is related more to annual per capita availability rather than to money supply. The estimate suggests that a reduction of one pound per capita per year in total foodgrains availability would push up that year's average retail price of coarse rice by 0.23 rupee per maund. On the other hand, a reduction of the money supply by one crore rupees would restrain retail prices during the associated fiscal year by less than 0.06 rupee per maund. Ninety-three per cent of the variance in retail rice price can be explained in terms of the two independent variables<sup>8</sup>. Table 58 presents the data used in this study.

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8. Cf. A.K.M.G. Rabbani and R.C.Repetto, "Foodgrains Availability, Money Supply and the Price Level in East Pakistan", Pakistan Development Review, Summer, 1968.

TABLE 58

FOODGRAINS AVAILABILITY, MONEY SUPPLY AND PRICE LEVELIN EAST PAKISTAN

Year	Average Retail Coarse Rice Price (Rs. Per Maund)	Availability per Capita (lbs per head per year)	Estimated Year End Money Supply (Rs. Crore)
1959-60	26.6	338	143
1960-61	24.5	367	149
1961-62	25.4	360	184
1962-63	27.1	352	195
1963-64	23.8	374	235
1964-65	25.1	368	260
1965-66	29.1	365	289
1966-67	38.7	337	311
1967-68	36.0	348	306

Source: A.K.M.G.Rabbani and R.C.Repetto, "Foodgrains Availability, Money Supply and the Price Level in East Pakistan", Pakistan Development Review, 1968, Table 1.

#### 4. The Food Situation in West Pakistan:

West Pakistan, which from times immemorial has been an important foodgrain producing area in India, also became a food deficit area in the 1950's. There was a marked increase in the consumption of wheat and rice in West Pakistan between 1955 and 1959 while the consumption and production of coarser foodgrains remained almost unchanged. Taking all foodgrains together consumption in West Pakistan was 20 to 25 per cent higher in 1959 than in 1955 and was far in excess of either population increase or rise in per capita income. As the consumption of foodgrains exceeded domestic production, in the province, net imports of wheat increased substantially. The Government needed large quantities of foodgrains especially wheat for controlled distribution in urban areas. The distribution of wheat through Government depots which was managed through compulsory procurement, plus imports and releases from stocks averaged over one million tons annually during the period 1957-60 as against 0.7 million tons annually in the preceding three years. The year 1955-56 was a year of poor crops both in East and West Pakistan and net availability of wheat and rice in West Pakistan was considerably reduced and their prices started rising significantly since then. Even the controlled prices of wheat and rice in the province had to be raised due to general food shortage since 1955-56. While the food requirements of the province continued to rise with population growth, urbanization and industrial development, production failed to keep pace with the rising demand for foodgrains. Moreover, foodgrain procurement did not rise in proportion to the rise in production despite the fact that procurement prices were raised by the Government.

The total quantity of wheat procured during 1957-59 was only 3 per cent higher than in 1954-56 while production over the period increased by 10 per cent. This indicates that either consumption of foodgrains in the rural areas was rising so that marketable surpluses did not increase in proportion to the rise in production or that free market prices of foodgrains were lucrative enough to divert part of the marketable surpluses to that direction despite compulsory procurement scheme of the Government. Probably both these trends were true for the First Plan period when there was a general food shortage in the country. Although the net availability of wheat in West Pakistan continued to rise after 1955-56, wheat prices ruled high due to rapidly rising demand for food in the province. Table 59 shows the net availability of wheat and rice in West Pakistan and their prices in the First Plan period.

The over-all food position remained satisfactory during 1960-61. The yield from wheat crop harvested in April/May 1960 amounted to 3.88 million tons of which West Pakistan produced 3.85 million tons. This indicates a small rise over the previous year. The price of wheat, however, went up during the year as a consequence of decontrol. Import of large quantities of wheat continued under the aid programme as well as under direct purchase arrangements. In 1961-62, the area under wheat crop increased by 2.2 per cent and production also increased by 4.1 per cent to 3.94 million tons. Consequently, the price of wheat, ruling between Rupees 14.50 and Rupees 17 per maund in February 1962 dropped in June and ranged between Rupees 11.50 and Rupees 14 per maund. In 1962-63 again there was a good crop but import requirements increased because of Government policy of building up stocks and to make up the food shortage in East Pakistan where the rice crop had a set back. The Government purchased

TABLE 59NET AVAILABILITY AND PRICE OF WHEAT AND RICE IN WEST PAKISTAN 1954-60

Year	Wheat, Net Availability ( 000 Tons )	Price Rs. Per Maund	Rice, Net Availability ( 000 Tons )	Price Rs. per Maund
1954-55	3587	8.94	746	18.25
1955-56	3163	10.88	695	18.94
1956-57	3806	14.50	828	23.88
1957-58	4194	13.06	736	28.50
1958-59	4107	14.75	770	26.25
1959-60	5629	13.25	816	31.91

Source: P.I.D.E, A Measure of Inflation in Pakistan, Appendix A  
Table 1 and 2.

large quantities of wheat from different markets and therefore the price of wheat went up by March 1963 and ranged between Rupees 15.50 and 16.50 per maund. The area under wheat was estimated at 12.5 million acres and showed a slight decrease of 0.7 per cent as compared with last year. The decrease in acreage was due to unfavourable weather conditions and production also correspondingly registered a decline of 0.7 per cent. The price of wheat in different centres of West Pakistan showed a rising trend during greater part of 1964. The quotations of average quality wheat were Rupees 1.50 to Rupees 2 per maund higher as compared with 1963.

The acreage under wheat crop increased by 1.9 per cent in 1964-65 due to sufficient rains and adequate supply of canal water. High price of wheat during the preceding year also contributed towards increased acreage. The production of wheat was estimated at 4.4 million tons compared to 4.1 million tons in 1963-64 and this exceeded the Second Plan target of 4.3 million tons. Imports of wheat during 1964-65 (up to the end of March 1965) were 1.26 million tons against 1.51 million tons in 1963-64 and 1.61 million tons in 1962-63. Out of the total imported quantity of wheat, 0.1 million tons were supplied to East Pakistan and 1.16 million tons to West Pakistan. In 1965-66, there was a marked fall in the production of wheat in West Pakistan resulting from unfavourable weather conditions. The wheat crop in this year was only 3.9 million tons compared to 4.4 million tons in 1964-65. However, the supply position of wheat remained easy as a result of adequate imports from abroad and liberal releases from government stocks. Harvests in 1966-67 were again very bad and two successive bad harvests created a serious food gap. This necessitated heavy imports of foodgrains in 1966-67 estimated at 1.5 million tons. A large part of these had to be financed from the country's own foreign

exchange resources as the P.L. 480 food imports were drastically cut. The shortfall in wheat production and slow arrivals of wheat imports created scarcity conditions with a steep rise in prices. The price of wheat during July-December 1966 ranged between Rupees 14.50 to Rupees 34 per maund against Rupees 12 to Rupees 19.50 per maund during the corresponding period of the previous year. However, with some rains in February and March and arrivals of more imported wheat, the prices began to decline. In April 1967, the prices of wheat in West Pakistan ranged between Rupees 20 and Rupees 30 per maund and the declining trend continued with the coming of new wheat crop in the markets. In the following year, the food position showed a marked improvement. The production of wheat was about 25 per cent higher in this year and arrivals of imports were also fairly satisfactory. Increased supply in the market lowered the prices of almost all foodstuffs. However, the total foodgrains deficit in the country for 1967-68 was estimated at 2.4 million tons which included 0.35 million tons for reserves in West Pakistan and about 0.3 million for reserves in East Pakistan.

##### 5. East-West Food Position: A Comparison:

On the whole, West Pakistan has had better food supplies than East Pakistan and the prices of staple foodgrains ruled much higher in the East than in the West. A.C.S.O survey of household income and expenditure in Pakistan indicates that the per capita consumption of all food items except rice and fish is higher in West Pakistan than in the East<sup>9</sup>. It is obvious that consumption is determined mainly by availabilities. Table 60 shows the monthly per capita consumption of major food items in East and West Pakistan and the ratio of West to East. The lower consumption of most food items in East Pakistan is

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9. See C.S.O, Report on the Quarterly Survey of Current Economic Conditions in Pakistan, Household Income and Expenditure, July 1963-June 1964, (Karachi, 1967).

TABLE 60MONTHLY PER CAPITA CONSUMPTION OF MAJOR FOOD ITEMS INEAST AND WEST PAKISTAN AND THEIR RATIO

(Based on Consumer Survey, 1963-64)

Food Items	East Pakistan ( Seers )*	West Pakistan ( Seers )*	West/East
Rice and Wheat	14.79	15.07	1.02
Rice	13.85	1.40	0.10
Wheat	0.94	13.67	14.54
Pulses	0.42	0.75	1.78
Potato	0.22	0.40	1.82
Sugar	0.29	1.09	3.76
Meat	0.30	0.48	1.60
Fish	1.01	0.06	0.06
Milk	0.96	3.90	4.06
Fats and Oil	0.21	0.49	2.33

\* One Seer is equal to 2.057 pounds.

Source: M.I.Khan, "Aggregative Analysis of Food Consumption in Pakistan", Pakistan Development Review, Winter, 1969.



partly due to lower per capita incomes in that part as compared with West Pakistan and partly to lower per capita availability of all these items. Due to much lower availabilities and higher demand, the prices of most food items including staple foodgrains have ruled higher in East Pakistan than in the West. While the average price of rice in East Pakistan has most of the time ruled around Rupees 30 per maund, the price of wheat in West Pakistan has rarely exceeded Rupees 20 per maund. The fact that East Pakistan has experienced more inflationary pressures than West Pakistan during most of the period under study can be largely explained by the high and rapidly rising prices of food items. A large population with a higher rate of population growth coupled with limited food supplies and other essential commodities and significant transport difficulties was bound to experience more inflationary pressures than the other wing which has a smaller population and is relatively well off in real terms. Transport bottlenecks have especially come in the way of adequate supplies of foodgrains in East Pakistan. Government's attempts to meet food shortages in the Eastern wing especially in the case of floods and other calamities have been greatly foiled due to inadequate transport facilities and difficulties in mobilizing the food resources.

## CHAPTER VII

### COMMERCIAL POLICY AND INFLATION

In an under-developed country, with limited productive capacity and real resources, an important way of supplementing the domestic supplies and of holding the price level within reasonable limits is to maintain a high level of imports and to increase the import capacity of the economy. This may be possible both by increasing the export earnings of the country and also by acquiring greater external resources. In Pakistan, attempts have been made in the past to increase the inflow of external resources and quite successfully too. But the commercial policy especially the exchange rate policy pursued in the course of economic development has not fully served the purpose of maximizing the export earnings and thereby increasing the import capacity of the country. On the contrary, it has tended to severely restrict import supplies in a ruthless bid at import substitution and has substantially raised the prices of imported commodities in domestic markets. It has also given rise to inefficient and high-cost productive units and mal-allocation of resources in the economy. On the whole, the commercial policy has not only failed to improve the balance of payments position of the country but has also contributed to inflation. These issues are discussed at some length in the present chapter.

#### 1. The Exchange Rate And Import Policies:

Pakistan's exchange rate policy has from the very beginning been closely linked up with the policy of industrialization and import substitution. At the time of partition, Pakistan had very little

manufacturing capacity. The existence of a fairly wide market and the availability of raw materials for consumption goods industries created an environment for industrialization. The Government was also keen on import substitution measures and diversification of a predominantly agricultural economy. The first 'Statement of Industrial Policy' was announced by the Government in 1948 which emphasized the need for industrialization with a view to utilize the domestic raw materials and labour supplies. Priority was given to consumer goods industry for which raw materials were locally available and a relatively simple technology was needed. The protection given to domestic industry in under-developed countries usually consists of: (1) an over-valued exchange rate that keeps the prices of imported investment goods relatively low and encourages investment particularly in the capital-intensive industrial sector. The over-valued exchange rate is also maintained on the assumption that the foreign demand for the country's exports (which comprise mainly of primary products) is inelastic, (2) the over-valued exchange rate is combined with a direct import control system and protective tariffs. Sometimes, a multiple exchange rate system is also adopted to subsidize exports and to maintain a discriminating rate for imports. In Pakistan, all the above measures have been adopted to encourage industrialization and import substitution.

The first decision with respect to the exchange rate policy and to the incentives given to domestic industry came in September 1949 when Pakistan decided not to devalue her rupee while Britain and India did. It was expected that the non-devaluation decision would have a favourable impact on the internal price level and that the lower import costs ( in terms of domestic currency ) of machinery and other

capital goods would provide a stimulus to the country's industrial growth. Some improvement in the terms of trade through switching off purchases from hard to soft currency areas was also expected. The non-devaluation decision of Pakistan meant that while its par value remained unchanged viz-a-viz the U.S. dollar, the rupee appreciated in terms of the pound sterling. A major threat to the viability of Pakistan's new exchange rate arose from India's refusal to recognize it. The trade deadlock with India resulted in a serious dislocation of Pakistan's trading activity and the challenge was met by an attempt to diversify the country's exports and imports. Later, the onset of the Korean boom made Pakistan's task much easier. By February 1951, India also recognized the par value of Pakistan's rupee and trade between the two countries revived to some extent. Due to the massive foreign exchange earnings during the Korean boom, the country entered a new phase of import liberalization. During the period from mid 1950 to late 1952, imports were very freely available under the Open General License System. Difficulties, however, arose when the commodity boom began to taper off in early 1952. Consequently, import controls were introduced in August 1952 which remained the sole basis of licensing decisions up to 1959 when the export bonus scheme was introduced.

The recession in international commodity prices continued unabated and by 1953-54 Pakistan's export earnings had fallen to Rupees 13,970 million (as against the 1950-51 level of Rupees 24,339 million). Meanwhile, reserves had slumped to Rupees 6305 million in June 1954. It was becoming clear that Pakistan would have to revise its thinking on the exchange rate issue in order to strengthen its balance of payments position. The following year, 1954-55, witnessed a nominal surplus of Rupees 9.9 million in the

balance of payments but this was achieved at the expense of a severe restriction of imports and the consequent slowing down in the tempo of development. Under the pressure of circumstances, the decision to devalue was announced on August 1, 1955. This measure restored the value of Pakistan rupee viz-a-viz pound sterling and the Indian rupee to the ratio prevailing before September 1949 and scaled down the par value with the U.S. dollar. The devaluation decision was backed up by the argument that significant structural changes had taken place in the economy. While domestic industrial capacity had expanded significantly and reduced the country's dependence on foreign consumer goods, there was pressing need to push up exports both of raw materials and manufactured articles. The balance of payments consideration less vital in 1949, had become paramount in 1955.

The exchange rate adjustment proved successful and there was a current account surplus of Rupees 361.8 million in the balance of payments during 1955-56. But the beneficial effects of devaluation proved to be short-lived due to the operation of two major factors. The emergence in early 1956 of an acute food shortage in both wings of the country necessitated heavy food imports during 1956-57 and 1957-58. Secondly, the deficit financing operations of the Government and the consequent monetary imbalance within the country had serious repercussions on the balance of payments. The accentuation of domestic inflationary pressures reflected in the continuous decline in foreign exchange reserves. These reserves had been almost halved from Rupees 1394.6 million in June 1956 to Rupees 715.1 million in October 1958. Another devaluation was in view but the newly established military Government was advised by some foreign experts to introduce a system

of multiple exchange rates instead of an open devaluation. Consequently the export bonus scheme was introduced in January 1959 which was meant to subsidize the non-traditional exports and to allow imports of specified commodities at discriminating rates. Under this scheme, exporters of permissible items are allowed to retain certain specified portions (ranging from 20 to 40 per cent) of their foreign exchange earnings which can then be either sold in the open market or used for the import of specified items. The eligible list of bonus imports originally comprised 219 items but was greatly expanded in the course of time. Generally, items either of an inessential nature or for which adequate production capacity is available in the country have been transferred from import licensing (where exchange is provided by the State Bank of Pakistan) to the bonus import list. For the latter, importers must earn bonus vouchers or purchase them in the market. These vouchers are freely traded in an organised market and generally earn a premium ranging between 150 to 200 per cent. The scheme was a sort of a concealed and partial devaluation which applied to specified commodities. Nevertheless, the scheme marked the beginning of an era of import liberalization for the first time since the introduction of import controls in 1952.

Alongside the export bonus scheme, a system of automatic licensing was also introduced. Under this system, for a list of commodities laid down in the import policy, category holders could get automatic licenses as soon as they had utilized their previous license. In 1961, the Open General License was once again introduced to facilitate the entry of new importers. The goods and monetary limits for this license were fixed for each half-yearly shipping period. Gradually an increasing number of items were placed on the Open General License

but over 90 per cent of commercial licensing was done within the category system. In 1964, a free list was also introduced which is widely considered to be the most important element of import liberalization<sup>1</sup>. A major part of free list imports were financed by foreign aid but the country also had to commit its own foreign exchange earnings to finance a part of these imports. In 1965, liberalization of imports was partly reversed by a tightening of import controls in view of the foreign exchange difficulties caused by the cut-back in foreign aid after the Indo-Pakistan war. The Open General License went into abeyance and the free list was drastically reduced. In this period, the bonus voucher system was more extensively used for the import of raw materials. After the revival of foreign aid, suspended in the period following the hostilities, the foreign exchange position improved again and the introduction of a cash-cum-bonus list in 1967 marked a return to the liberalization movement. Under this arrangement importers of specified items can obtain import licenses entitling them to foreign exchange at the official rate, provided their applications are accompanied by bonus vouchers of the value of 50 per cent of their exchange requirements. A system of export performance licensing also applies to some 143 commodities including ~~the~~ <sup>in</sup> particular jute manufactures. Under this scheme import licenses over and above the entitlement under normal licensing are issued at rates 2 1/2 to 30 per cent of the f.o.b value of exports. Import liberalization in the 1960's was made possible by the expanded foreign aid programme which made the foreign exchange position relatively comfortable and allowed a net increase in the

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1. Cf. P.S. Thomas, "Import Licensing and Import Liberalization in Pakistan", Pakistan Development Review, Winter, 1966.

number of licenses issued by the Government to importers. Economic development in this decade was greatly assisted by liberalized imports.

Although Pakistan rupee was devalued in August 1955, in the face of rising demand for foreign exchange in the process of economic development and the failure of exports to rise correspondingly causing balance of payments difficulties and depletion of foreign exchange reserves, the rupee always remained seriously over-valued. Some studies have been made to approximate the extent of over-valuation of Pakistan currency at the official exchange rate. In the absence of quantitative controls on imports, prices of imports and import competing goods would have been set by the c.i.f prices of imports, plus tariffs and other indirect taxes, plus a normal trade mark-up for the commodity concerned. Difference between this price and the actual domestic market price may be attributed to the excess demand for imports. M.L.Pal has made comparisons of such prices in Pakistan in two studies covering the period close to the end of the Second Plan<sup>2</sup>. For the first survey in Karachi in 1964, unweighted average percentage mark-up for the commodities surveyed was around 60 per cent while for the second survey in Chittagong and Karachi 6 months later and with slightly different sample of goods, the average mark-up was between 40 and 45 per cent. Broadly speaking the domestic value of imports in Pakistan in the mid 1960's exceeded their full duty paid value at the official exchange rate by approximately 50 per cent whereas, the normal trade mark-up is reported by Pal, on the basis of trade inquiries, to be about 12 per cent. The excess

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2. Cf. M.L.Pal, "The Determinants of the Domestic Prices of Imports" Pakistan Development Review, Winter 1964 and "Domestic Prices of Imports in Pakistan: Extension of Empirical Findings", Pakistan Development Review, Winter 1965.



mark-up is an indication of the implicit shadow price of foreign exchange for imports.

Using the Pal data, Aminul Islam has also estimated the extent of over-valuation of Pakistan's currency at the official exchange rate in a different way<sup>3</sup>. The magnitude of the excess of demand price over supply price of foreign exchange as a percentage of the latter has been defined as the rate of over-valuation of the domestic currency at the official rate of exchange. The domestic market price of imports minus the normal trading profit per unit of imports minus the cost of distribution per unit of imports is defined as the scarcity price of a unit of foreign exchange. The excess of scarcity price of a unit of foreign exchange over the official rate of exchange as a percentage to the latter is the degree of over-valuation of currency. The c & f value of a unit of imports is assumed to be equal to the official price of a unit of foreign exchange. Normal trading profit has been assumed to be 20 per cent of the c & f value and the cost of distribution to be 10 per cent of the c & f price. On the basis of these computations, the over-valuation of domestic currency is reported by Islam to be 92 per cent in the period June-August 1964. This includes the import taxes paid by the importers and thus the basis of estimation is different from the one adopted by Pal. This is an estimate of the over-valuation of currency in comparison with the price of foreign exchange required to clear the market for imports in the absence of fiscal or administrative controls.

The over-valuation of domestic currency has been sustained through a system of import controls, protective tariffs and multiple

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3. Cf. A.I. Aminul Islam, "An Estimation of the Extent of Over-valuation of the Domestic Currency in Pakistan at the Official Rate of Exchange, 1948-49 - 1964-65", Pakistan Development Review, Spring 1970.

exchange rates discriminating against imports. In addition to the quantitative import controls explained earlier, the over-valuation of rupee has also been sustained through regulatory and protective tariffs. An elaborate cascaded tariff structure has been evolved to encourage import substitution and to restrict imports. Imports of consumer goods and consumer durables have been most strongly discriminated against with tariffs exceeding 100 per cent. Domestic production of these goods has been greatly encouraged. Lower rates of duty apply to intermediate goods and the lowest to capital goods. With the liberalization of imports in 1959, greater importance was given to regulatory tariffs and their rates increased very sharply thereafter. All tariff rates increased after 1959-60 but the rates on consumer goods rose much more than those on semi-manufactures while those on unprocessed raw materials rose least of all. Between 1959 and 1963 import duties had risen by about one-third with increases ranging from 11 per cent on certain processed raw materials to 115 per cent on semi-luxury consumer goods. In July 1964, a regulatory duty ranging from 5 to 20 per cent ad valorem was imposed on free list imports. In January 1965, duties on capital machinery imports were raised in West Pakistan from 12.5 per cent to 25 per cent ad valorem and from 7.5 per cent to 20 per cent in East Pakistan. In November 1965, after the war with India, import duties and sales tax were raised by a defence surcharge of 25 per cent. By 1966, the import taxes were almost 75 per cent higher than in 1959. Table 61 gives the average rate of duty on imported goods by type of commodities.

## 2. Impact of Trade Policies on Prices and Balance of Payments:

The trade restricting policies pursued by the Government of Pakistan such as import controls, protective tariffs and discriminating exchange rates for exports and imports in the form of export

bonus scheme have tended to restrict availabilities in the economy and thereby to contribute directly to inflation. Whenever imports were liberally available, prices remained stable and the country was able to maintain high rates of economic growth. The main reason for the marked success of Pakistan's Second Plan both with respect to rates of growth and price stability has been a more liberal supply of imports made possible by the expanded foreign economic aid programmes and import liberalization efforts. On the contrary, the principal reason for low rates of growth and higher rate of inflation in the First and Third Plan periods has been the restricted supply of imports and inadequate foreign exchange reserves. In fact, attempts to develop an economy without adequate supplies of foreign exchange are bound to be frustrated. What is more, adequate attempts have not been made in Pakistan to increase the country's export earnings or to adjust the exchange rate in a manner to create equilibrium in the foreign exchange market to the extent this was possible. As we shall see below, the export bonus scheme has suffered from some serious defects and has not adequately fulfilled its purpose of accelerating exports.

An important objective of import controls and tariffs in Pakistan has been to give protection to domestic industry and thereby to encourage import substitution. But the import restricting policies have given rise to inefficient and high-cost industrial units which have tended to raise the domestic prices of import substitutes to a considerable extent. A temporary protection and artificial support may be justified to an infant industry for some time but, with the lapse of time, industries should be able to operate without artificial support. What has actually happened in Pakistan is that industries

TABLE 61

## Average Rate of Duty on Imported Goods by Types of Commodity

Description	1955- 56	1956- 57	1957- 58	1958- 59	1959- 60	1960- 61	1961- 62	1962- 63	1963- 64
Consumption Goods									
(a) Essentials	35	35	35	35	35	55	55	55	56
(b) Semi-Luxuries	54	54	54	54	54	111	111	111	116
(c) Luxuries	99	99	99	99	99	140	140	140	142
Raw Materials for									
Consumption Goods									
(a) Unprocessed	26	26	26	26	26	27	27	27	30
(b) Processed	43	43	43	43	43	50	50	48	51
Raw Materials for									
Capital Goods									
(a) Unprocessed	23	23	23	23	23	28	28	28	31
(b) Processed	38	38	38	38	38	40	40	39	42
Capital Goods									
(a) Consumer durables	71	71	71	71	81	85	85	85	89
(b) Machinery and Equipment	14	14	14	14	14	17	17	17	17

Source: Stephen R. Lewis, Economic Policy and Industrial Growth in Pakistan, Table 14, p.72

have become more rather than less dependent on protection and subsidies. Protective tariffs and export subsidies have resulted in a mushroom growth of industry comprising of inefficient and high-cost industrial units. As we shall see, the combined effect of economic policies, has been to make the establishment of inessential import-substituting industries more profitable than export-oriented industries. The inessential growth of industries has created idle capacity which has been on the increase as their import requirements have increased at a faster rate than the country's capacity to import. At the same time, the establishment of a large number of inessential consumer goods industries have been instrumental in liberalizing consumption and discouraging savings. This in turn has stood in the way of export expansion and strained the balance of payments position of the country.

An important feature of Pakistan's exchange rate policy is the export bonus scheme which is in effect a multiple exchange rate system providing different rates of exchange to exports and imports. The scheme was meant to accelerate the country's exports by subsidizing the export industries. But in practice, it has proved to be more import-substitutive than export-orienting and has resulted in a serious mal-allocation of resources in the economy. On the whole, it has done more harm than good to the country in the course of time. It has in the process led to mal-allocation of resources, under-utilization of capacity and wasteful use of the country's foreign exchange resources. Some of the demerits of this scheme are discussed below.

On the one hand, this scheme has raised the price of foreign exchange to exporters of non-traditional products but has not given any incentive to traditional agricultural products

except rice. While the scheme has tended to increase non-traditional exports by manipulating the implicit exchange rate for them, it has depressed the exports of traditional agricultural products like raw jute and raw cotton. In some statistical studies, the price elasticity of demand for Pakistan's major agricultural exports has been found to be significant and high due partly to the introduction of synthetic substitutes and the elasticity of export supply is also in most cases significant and greater than unity<sup>4</sup>. Thus the export bonus scheme as currently operated has not given the same advantage to Pakistan's total exports as an outright devaluation would have done.

The bonus system has also distorted the pattern of resource use towards a less efficient allocation and has deprived the country of potential foreign exchange earnings. In a study, Ghulam Mohammad has shown that the introduction of the bonus scheme for rice led to a shift in the relative acreage from cotton to rice even though foreign exchange earnings per acre of land are higher for cotton than for rice<sup>5</sup>. In another article, Richard Mallon considered the relative advantage of exporting raw cotton and raw jute as compared with their manufactures and concluded that foreign exchange earnings are higher when the former are exported but that the pattern of exports has been biased in favour of cotton and jute textiles since the exports of these commodities were subject to a bonus whereas the export of raw cotton and raw jute received no bonus and in addition have been subject to an export tax<sup>6</sup>. Lesser foreign exchange earnings

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4. Cf. Nurul Islam, "Export Incentives And Responsiveness Of Exports In Pakistan: A Quantitative Analysis", Discussion Paper No:58, (Economic Growth Centre, Yale University), October, 1968.

5. Cf. Ghulam Mohammad, "Some Physical And Economic Determinants of Cotton Production in West Pakistan", Pakistan Development Review, Winter 1963.

6. Cf. Richard Mallon, "Export Policy in Pakistan", Pakistan Development Review, Spring, 1966.

as compared with devaluation imply a lesser supply of imports in the economy and higher prices of import substitutes. This has had a direct bearing on the general price level in the economy.

Moreover, the export bonus scheme has tended to encourage inefficient industrial units that are absolutely incapable of competing internationally. Under the scheme, the exporters receive a higher domestic price than the official exchange rate for their earnings of foreign exchange which is the export subsidy. The export subsidy equals the rate of bonus allowed to the industry multiplied by the rate of bonus voucher premium. For example if the rate of bonus is 30 per cent or 0.30 and the rate of bonus voucher premium is 170 per cent or 1.70, the export subsidy would be 51 per cent of the total foreign exchange earnings of the industry concerned. The rate of bonus allowed to an industry is higher, the lesser is its competitiveness in the international market. If the exporter cuts his export price by the amount of bonus and if the foreign demand for his exports is elastic, he can export more and earn more foreign exchange. The implicit rate of subsidy provided by the scheme in relation to value added diverges widely even at the same nominal rate of bonus entitlement and this rate is higher the more inefficient is an industry. Thus the scheme has tended to encourage the growth of a large number of inefficient and high-cost industrial units in the country in the course of time.

What is more important from our point of view is the fact that the scheme, as administered in the course of time, has provided an allocative bias in favour of import substitution by raising the prices of imports more than would have been the case in the event of devaluation and relatively freer imports and has thus provided

heavy protection to import substitutive industries. This has in turn contributed to the rise in general price level as the domestic infant industries always have a higher cost of production than the established international industries in the same line. The system of exchange control and import licensing tend to favour import substitution by restricting imports and raising the prices of import substitutes in the domestic market thereby increasing the marginal profitability of new investment in import substitution industries as opposed to investment in export industries. The export bonus scheme was intended to encourage investment in export industries by giving an export subsidy which is determined by the rate of bonus and the level of bonus voucher premium. The scheme was also expected to reduce the protection provided by the exchange control and import licensing systems by allowing larger imports than was possible in the absence of this scheme. But in fact the scheme as operated in Pakistan has implied net subsidy for the import-competing industries and has thus encouraged import substitution. This is further explained below.

The export subsidy can be regulated either by changing the rate of bonus or by allowing the level of premium to change or both. While the rate of bonus is directly fixed by the Government, the level of premium is determined by the forces determining the import and export trade. Now, the rate of bonus has not changed much since 1959 except in 1967 when these rates were substantially raised by the Government. On the other hand, the bonus list was greatly expanded in the course of time so that the demand for bonus vouchers increased at a fast rate than their supply and the average rate of premium continued to rise from 121 per cent in 1961 to 170 in 1967.



While a rise in the bonus rate tends to encourage export expansion relatively, a rise in the level of premium emphasizes import substitution by raising the prices of imports under the scheme. The implicit tariff protection provided by the scheme can be expressed in the following way:

$$t = \frac{1+v}{1+bv} - 1$$

where,

$t$  = the implicit tariff protection.

$v$  = the rate of premium on bonus vouchers and

$b$  = the rate of bonus.

The implicit protection provided by this scheme increased from 0.77 in 1961 to 0.88 in 1966 and declined again to 0.83 in 1967 due to a rise in the bonus rate<sup>7</sup>. Thus the scheme so far operated has raised the prices of bonus imports and import substitutes substantially and has encouraged import substitution more than export promotion. Like import controls, it has encouraged investment in import substitution industries more than in export industries.

The export bonus scheme has also encouraged monetary indiscipline. The dangers of excessive monetary creation have been concealed by this scheme as the impact has continuously been cushioned by the deteriorating effective exchange rates. In the case of a fixed exchange rate, careful consideration is given to all the pros and cons before a decision is made to move from one rate to another. But in the case of this scheme, the effective exchange rates have been allowed to deteriorate without the gravity of the action being fully realized.

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7. Cf. S.N.H Naqvi, "On Optimizing" Gains "from Pakistan's Export Bonus Scheme", Journal of Political Economy, January/February, 1971.

The scheme is in fact a de facto devaluation with respect to certain commodities without the advantages of a total devaluation.

Finally, the export bonus scheme has led to great uncertainty in business and investment decisions, with sharply fluctuating prices of bonus vouchers and frequent shifts of imports from one category to another as also adjustments in bonus rates. In such a situation, industries importing capital equipment, raw materials and spare parts are faced with difficulties in formulating stable production plans and pursuing a rational cost policy.

In view of the defects of the export bonus scheme which is in effect a concealed and partial devaluation and due to the serious over-valuation of rupee, there is a consensus among economists in Pakistan that the rupee should be devalued at least by 50 per cent and this may be coupled with some relaxation in import controls. This would assist in raising the level of both exports and imports and thereby help raise the over-all growth in the economy. But the Government view on this point is that the advantages of an over-valued currency accrue in the form of lower import bill for development imports and lesser burden of external debt repayment. That is why the devaluation proposals have always been resisted by the authorities in Pakistan. The main argument against a total devaluation of currency is that it would cause a cost inflation through increased import prices and development costs. But the point is whether devaluation causes any more cost inflation than any other method of improving the balance of payments like disguised devaluation in the form of tariff increases and export subsidies. Devaluation is no more inflationary than other measures and in fact it is less because other measures lead to a less efficient use of resources and hence less output. Devaluation cannot

be regarded as the cause of inflation; it is most frequently a reaction to inflation. For countries which have experienced only low rates of inflation, there is plenty of evidence that devaluation is not quickly wiped out in the form of higher prices<sup>8</sup>. Although the real effect of devaluation and unified exchange rate would take long time to develop but in the long-run it would be useful to have a unified and realistic exchange rate as compared with an over-valued and artificially maintained exchange rate. Under conditions of inflation particularly, the multiple exchange rate system creates additional difficulties. These include discouragement of basic exports through maintenance of penalty export rates at over-valued exchange rate, distortions in domestic production and investment arising from multiple import and export rates and local currency losses. An important advantage of exchange rate adjustment, that is often overlooked, is that it would increase the inflow of foreign investments into the country and would thus greatly relieve the foreign exchange crises and set-backs to economic development experienced in the past.

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8. Cf. I.M.D. Little, Tibor Scitovsky and M. Scott, Industry And Trade in Some Developing Countries: A Comparative Study, (Oxford University Press, London, 1970).

CHAPTER VIIITHE STABILIZING ROLE OF FOREIGN AID

Foreign economic aid is an important source of real resources for under-developed countries undergoing development. It tends to promote savings investment and economic growth in them and relieves the pressure on prices and balance of payments that would otherwise be felt in the course of economic development. In the present chapter we discuss the impact of foreign economic aid on Pakistan's development with special reference to its effect on the price situation. For our purposes we define foreign aid to include grants-in-aid and loans received from foreign governments, loans from international financial institutions, the U.S./P.L. 480 imports generating counterpart funds and technical assistance programmes. Foreign private investment is thus excluded because economic aid is only that part of capital inflows which normal market incentives do not provide and which can be acquired only through institutional channels including the governments of friendly countries.

It is now commonly accepted that foreign economic aid can accelerate the development of an under-developed country by providing it additional imports and by raising the level of investment in it. If a country tries to develop without external assistance, it will have to provide adequate capital equipment and technical skill from its own resources and export earnings. Self-sustained economic development would thus require substantial increase in skills,

domestic savings and export earnings which would be difficult for a newly developing country to achieve on its own. Foreign economic aid is supposed to relax some of the bottlenecks created in the process of economic development such as shortage of skill and technical know-how, domestic savings and foreign exchange<sup>1</sup>. The main function of foreign economic aid is to increase the rate of domestic capital formation in the recipient country to a level where self-sustained economic growth may be possible. Economic aid is supposed to raise the absorptive capacity of the country, that is its capacity to mobilize additional savings and investment<sup>2</sup>.

#### 1. Aid And Pakistan's Economic Development:

Starting with a very low inflow of foreign aid in 1955, Pakistan's economic development has been increasingly financed by foreign aid of different kinds so much so that now foreign aid has become an essential input in Pakistan's productive activities. The level of economic activities in Pakistan in a given year is to a great extent determined by the availability of foreign aid. In early years, greater part of foreign aid consisted of grant assistance from friendly countries. The proportion of grants, however, declined over the years and now only technical assistance and P.L. 480 commodities are provided on a grant basis. Economic aid so far received by Pakistan from various sources can be classified into four broad categories:

- (1) Project aid in the form of goods and machinery for purposes of a specific development project.

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1. Cf. H.B. Chenery and A.M. Strout, "Foreign Assistance and Economic Development", American Economic Review, September 1966 and also A.O. Hirschman, The Strategy of Economic Development, (Yale University Press, 1958), PP. 205-207.

2. Cf. P.N. Rosentein-Rodan, "International Aid For Under-developed Countries" Review of Economics and Statistics, May 1961, P. 107.

- (2) Non-project aid consisting of raw materials, fertilizers and other equipment for existing industries.
- (3) Technical assistance in the form of technicians, training facilities, equipment for training etc. and
- (4) P.L. 480 imports consisting of the United States' surplus agricultural commodities that are sold in Pakistan and converted into counterpart funds. These are utilized to meet the rupee cost of agreed development projects.

Most of Pakistan's foreign aid has, in recent years, been channelled through the Pakistan Aid Consortium organised in 1960 by the World Bank in collaboration with the leading aid-giving countries of the world. The Consortium met for the first time in Washington in October 1960 to consider the aid requirements of Pakistan's Second Plan. The foreign exchange cost of revised Plan was set at \$ 1774 million. In addition, the Planning Commission foresaw an additional foreign exchange expenditure of \$ 525 million outside the framework of the Plan. Thus the total amount of aid requested was \$ 2174 million of which 34 per cent was required in the form of non-project aid. Of the requested sum, \$ 1819 million were pledged by the Consortium countries and more than \$ 1300 million were actually disbursed in the Plan period. Pakistan's Second Plan had several features which gained the approval of Western aid-givers, for example, the encouragement given to private enterprise in the Plan which was supposed to provide about 40 per cent of total investment expenditures of the Plan, the Plan's emphasis on reducing the disparity between the eastern and the western wings of the country and the importance given to agricultural development in the Plan<sup>3</sup>.

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3. Cf. John White, Pledged to Development, (Overseas Development Institute, London, 1967) PP. 63-65.

The size of the Third Plan was much larger than that of the Second Plan namely Rupees 52,000 million and the estimated volume of foreign aid and foreign private investment required to finance it stood at \$ 3260 million. However, in view of the large size of the Plan, external resources were to constitute 32 per cent of total expenditure in the Plan period compared with 38 per cent in the Second Plan. For the first year of the Plan, Pakistan requested pledges from the Consortium amounting to \$ 500 million. When the Consortium met in July 1965 to consider the Plan, it approved its strategy but due to the changed attitude of the U.S.A towards Pakistan, the pledging session of the Consortium was indefinitely postponed. In 1966, however, the U.S.A decided to resume aid to Pakistan. Still the total availability and utilization of external assistance in the first three years of the Plan had been considerably lower than the Plan expectations. The pledges made by the Consortium and non-Consortium countries totalled \$ 1474 million or about 9 per cent less than the Plan estimate of \$ 1650 million for the three years and actual disbursements were even less, namely \$ 1348 million. Table 62 shows the inflow of foreign aid to Pakistan during the period under study and its ratio to G.N.P.

On the whole, the role of foreign economic assistance in Pakistan's economic development has considerably increased over the period under study. The share of foreign aid in the financing of aggregate investment increased from 14.9 per cent in 1954-55 to 44.1 per cent in 1959-60. In the Second Plan period, however, due to a high rate of economic growth and rapid increase in domestic savings, this proportion declined to about 38 per cent but in absolute terms, the flow of foreign aid to Pakistan was much larger during the Second Plan than ever before. In the Third Plan period also the foreign aid

receipts remained high in absolute terms but their proportion in aggregate investment further declined to about 32 per cent because of larger mobilization of domestic resources through increased tax efforts and greater reliance on deficit financing necessitated by cutbacks in foreign aid. Whereas in 1955-56, foreign aid comprised only 2.7 per cent of the G.N.P, its ratio to G.N.P increased to 5.9 in 1964-65 but declined again to about 5 per cent in the Third Plan because of reduced supplies. In 1967, official aid disbursements provided about 30 per cent of the aggregate imports in Pakistan.

Owing to its own limited foreign exchange earnings and large development programmes, Pakistan has heavily depended on foreign economic assistance from advanced industrial countries. Foreign aid has been playing and will continue to play a significant role in the economic development of the country. It has helped in building up economic infra-structure such as power plants, transport and communication facilities, vital industries etc and has also provided large quantities of foodgrains, industrial raw materials, machinery and spare parts. The main contribution of foreign economic aid to Pakistan's development lies in the following: (a) it has tended to raise the level of capital formation and of domestic savings in the country and (b) it has provided the country with development and non-development imports that could not be purchased out of the country's own meagre foreign exchange earnings.

The rate of capital formation in Pakistan has greatly depended upon the availability of foreign aid. Development programmes in industry, transport and other fields gained momentum whenever foreign aid was available in required quantities. On the other hand considerable idle capacity was reported in the industrial sector whenever due to reduced foreign aid, raw materials and spare



TABLE 62

Total Foreign Aid Received By Pakistan, 1955-68

Year	Value Received (Million Rupees)	Percentage to G.N.P.
1955-56	610	2.7
1956-57	864	3.2
1957-58	854	3.0
1958-59	922	3.3
1959-60	1395	4.4
1960-61	1433	4.1
1961-62	1407	3.8
1962-63	2081	5.3
1963-64	2333	5.6
1964-65	2688	5.9
1965-66	2311	4.6
1966-67	2851	4.9
1967-68	3456	5.6

Source: Government of Pakistan, Planning Commission, The Second Five Year Plan, Table 5, p.86. Final Evaluation of Second Plan, Statistical Appendix Table 4.1 and Mid-Plan Review of Third Plan, Statistical Appendix, Table 5.1.

parts were not easily available and fresh undertakings and projects were worst affected. Changes in foreign aid inflows have also affected the real national income and the per capita income through changes in capital formation. Since domestic savings are dependent upon the level of income, the aid inflows have influenced the level and the rate of domestic savings. One of the criteria for granting economic aid to under-developed countries by the aid-giving countries is the absorptive capacity of the recipient country, that is, its capacity to raise the level of domestic savings and capital formation corresponding to aid inflows as a step towards self-sustained economic growth. The aid-receiving country has to mobilize enough domestic resources to combine with external resources so as to use the foreign aid effectively. The rates of domestic savings and capital formation in Pakistan have corresponded well with the level of aid inflows. These rates were low in the First Plan period when aid inflows were at a low level. Considerable idle capacity was also reported in that period in the existing industries as there was an acute shortage of foreign exchange in the country. The pressure on prices in this period was aggravated by inadequate imports under excess demand conditions. The aid inflows were greatly expanded in the Second Plan period and these helped in raising the rates of capital formation, economic growth and domestic savings. With improved foreign exchange position it was also possible to liberalize imports. Due to high rates of growth in the economy together with liberalized imports, the price situation improved considerably in this period. In the Third Plan period again serious foreign exchange difficulties were experienced due to cut-backs in foreign aid. Both capital formation and domestic savings were therefore adversely affected in this period. Imports had to be restricted and pressure on prices increased further.

In the First and Second Plan periods, foreign aid financed nearly 36 per cent of the country's total imports and in the Third Plan about 32 per cent. These included both development and non-development imports including food imports. Most of these imports would not have been available without foreign aid inflows. The country experienced serious food shortages in the course of economic development and these deficits would have been much more pronounced if foodgrain imports had to be financed exclusively from the country's own foreign exchange earnings. In the absence of resources provided by foreign aid and the P.L. 480 programme, the country would have faced more serious inflationary pressures than it actually did and development programmes would have had to be curtailed.

As far as the price situation is concerned, the contribution of foreign aid is three-fold. Firstly, by providing necessary inputs, raw materials and capital goods, foreign aid accelerated economic growth and thus increased the domestic supplies of goods and services at a faster rate than would otherwise have been possible. Next, it directly supplemented the domestic output with different kinds of imports including those required for consumption purposes and thus helped in holding down the price level level. Foreign aid has financed almost one-third and in some good years even more of the country's total imports. If these imports had not been available, the pressure on prices would have been much more than actually experienced. Lastly, the P.L. 480 programme has been of special significance in supplementing the country's food supplies which have had a great bearing on the price situation. From the point of view of price situation therefore the effect of the U.S. P.L. 480 programme need to be studied in detail.

## 2. The Effect of P.L. 480 Programme:

The U.S. P.L. 480 programme has occupied a major place in the economic aid programmes in recent history. This programme covers imports of surplus U.S. agricultural commodities provided by or through the U.S. Department of Agriculture under the Public Law 480 of 1954. These shipments are arranged under three Titles. Title I of the Law provides commodities for commercial sale against payment in rupees from which counterpart funds are generated. Title II provides surplus commodities for emergency relief in the case of crop failures or other calamities. The sale proceeds of these commodities go into a separate fund held by the Government of Pakistan. In addition, surplus commodities are also provided under Title III of the programme which are distributed among the needy free of charge through voluntary charitable organizations. The ocean freight is paid by the recipient country in the case of Title I and by the A.I.D in other cases.

Local currency or counterpart funds are generated from the sale of commodities provided under various programmes. There are two types of local currencies generated by the U.S. commodity aid, namely:

- (1) Government of U.S. Funds and,
- (2) Government of Pakistan Funds.

Government of U.S. Funds arise out of (a) the rupee equivalent of the dollar payments made in the U.S.A by the U.S Department of Agriculture for supplies of surplus agricultural commodities under P.L. 480 Title I and (b) repayment of loans received from the DLF or those from counterparts. A special deposit account called the Deposit Account of the U.S.A Commodity Aid under P.L. 480 Title I is opened in the State Bank of Pakistan receiving these

credits. These funds are spent to meet the requirements of both the U.S. representatives in Pakistan and the Government of Pakistan.

On the other hand, the Government of Pakistan funds are of two kinds: (a) counterpart funds made up of the rupee equivalents of dollar disbursements made for imports under P.L. 665/138 ( Defence Support Programme ) together with customs duty, if any. These are deposited in a special account opened in the State Bank of Pakistan for this purpose and termed as Deposit Account of the U.S.A. Commodity Aid under P.L. 665/138. Except to the extent of 5% of the accumulation in this account which are transferred to the U.S representative in Pakistan for their expenses in local currency, the entire money is expendable by the Government of Pakistan with the prior approval of the A.I.D for the economic development of Pakistan, (b) Funds comprising the sale proceeds of commodities received as a relief measure under P.L. 480 Title II. These funds also go into a separate account opened with the State Bank of Pakistan under the name of Deposit Account of the U.S.A Commodity Aid under P.L. 480 Title II. Five per cent of the total accruals are placed at the disposal of the U.S. representatives in Pakistan for their local expenses. The balance is utilized in consultation with A.I.D for direct relief or relief works in areas hit by natural calamity like cyclones, floods etc.

The counterpart releases play an important role in the implementation of the country's development programmes. In 1960-61, for example rupee releases accounted for 36.2 per cent of the entire capital resources of the Government. Until 1966-67, all the sale proceeds of P.L. 480 shipments accrued in local currencies. From the year 1967-68, however, a portion has to be repaid in dollars spread over a period of 40 years, the first instalment being due 10 years

after the date of the last delivery of commodities in each calendar year. The outstanding amount carries interest at 2 per cent during the first ten years and 2.5 per cent during the next thirty years. Under the changed terms of the P.L. 480 programme, Pakistan will have to acquire necessary foreign exchange to repay a part of the sale proceeds whenever they are due for repayment. Nevertheless, the programme is still an important source of revenue for the Government. Pakistan has been the second largest recipient of the U.S surplus agricultural exports next to Yugoslavia and by the middle of 1967 had received commodities worth about \$ 1100 million. It is, therefore, important to investigate the effects of this programme on the monetary and price situation especially because its effects have been greatly debated in some recipient countries.

The P.L. 480 programme influences the price level in two ways. Firstly, it supplements the supply of consumption goods and raw materials especially foodgrains and thus brings about a stabilizing effect on the price level. In the absence of this programme, the pressure on prices especially food prices would have been much more than actually experienced. In the case of crop failures particularly, the P.L. 480 supplies enlarge and thus help the authorities in holding down the price level. However, the aggregate effect of the programme on the price level will be a combination of three effects namely (a) the real effect of the P.L. 480 imports on availabilities, (b) the monetary effects of the sale of P.L. 480 commodities and the consequent withdrawal of purchasing power from the public coupled with the effect of counterpart spending and (c) the effect of P.L. 480 imports on local agricultural production. These are now discussed further.

The food position in Pakistan began to deteriorate in the 1950's so that the country became a net importer of foodgrains and a large part of these came under the P.L. 480 programme. There was food control and rationing in the country and both wheat and rice were being distributed at controlled and subsidized prices. In face of the general food shortage in the country and the over-all inflationary situation, the P.L. 480 programme was a great boon as it provided food and other materials to the country. It tended to avert what could have been a very serious inflationary situation. Especially in the First Plan period, the programme helped a lot in checking a seriously inflationary trend in food prices which could have had undesirable effects on the general development of the country. Christopher Beringer points out that in the First Plan period, the effect and probably the aim of this programme was diversionary, that is saving of the country's foreign exchange on the food front. The average annual imports of P.L. 480 commodities under Title I in this period were about Rupees 230 million. It can be safely assumed that in the absence of P.L. 480 programme the quantity of food imports on hard currency account would have been smaller in spite of the severe food shortage in the country. If at least half of this amount would have had to be spent in any case, the foreign exchange saved through the P.L. 480 imports was about 7 per cent of Pakistan's average annual export earnings<sup>4</sup>.

In the Second Plan period, however, the P.L. 480 imports increased substantially and the expanded P.L. 480 programme went

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4. Cf. Christopher Beringer and Irshad Ahmad, The Use of Agricultural Surplus Commodities for Economic Development in Pakistan, (Pakistan Institute of Development Economics Monograph No: 12, Karachi, 1964) PP. 19-20.

beyond the limited objective of providing diversionary resources and substantial additional funds were made available through it for enlarging the size of development Plans. The best example of this is provided by the fact that nearly 50 per cent of the accruing local currency in the Second Plan period was spent on the Rural Works Programme, especially in East Pakistan, which was not originally provided in the Plan. Under this programme, the surplus rural population is employed in projects like the construction of rural roads, schools, medical dispensaries, canals etc. The programme is specifically labour-intensive and is designed to provide employment to the seasonally unemployed or under-employed rural population. The Rural Works Programme, by implication, required greater food supplies in the rural areas in order to support the increased consumption of the newly employed rural population detached from the farm and engaged in the village uplift projects. If food supplies had not been heavily supplemented by P.L. 480 imports, the rise in food prices especially in rural areas and also in the rest of the economy, would have been great. The surplus food programme has permitted a large increase in employment, wages and spending especially in the rural areas of East Pakistan without an undue pressure on food prices. The programme however need to be so managed as to protect farm incentives. The farmer needs both fair and remunerative prices as well as the infra-structure which the Rural Works Programme makes possible<sup>5</sup>.

In the first two years of the Third Plan, the P.L. 480 imports to Pakistan declined substantially due to the changed attitude of the United States Government on aid to Pakistan. In these

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5. Cf. R.V. Gilbert, "The Works Programme in East Pakistan", International Labour Review (Geneva, March 1964).



two years, the food prices increased significantly both because of crop failures and reduced availabilities under the P.L. 480 programme. In the third year of the Plan, however, normal supplies were resumed and this, together with good crops, brought down the food prices.

The value of P.L. 480 imports to Pakistan and their ratio to the gross national product are shown in Table 63. Chart VI shows the ratios of total foreign aid and P.L. 480 imports to the G.N.P. graphically.

In addition to the effect of the P.L. 480 programme on availabilities. Let us also examine its monetary effects which arise when the commodities received under the programme are sold and purchasing power is withdrawn from the public and counterpart funds are generated. Later, the counterpart spending transfers back a part or whole of the purchasing power withdrawn from the public. The implications of these transactions can be discussed further. Initially, the P.L. 480 imports mean a transfer of foodgrains and some raw materials from the donor country to Pakistan. When these commodities are sold in Pakistan, purchasing power is withdrawn from individuals and businesses to the credit of the Governments of United States and Pakistan. Money supply available to the rest of the economy is, therefore, reduced whereas cash balances held by the State Bank of Pakistan on behalf of the Governments concerned increase by the amount of these sales. To this extent, the P.L. 480 programme has deflationary effects in so far as the supply of consumption goods in the economy rises while an equivalent amount of currency has been withdrawn from circulation. But at the same time, the counterpart funds generated from the sale of commodities also give claim to the Governments concerned over the country's real resources. If the counterpart funds

accumulated through the sale of commodities in Pakistan are kept idle, the deflationary effect of public's reduced cash holdings would continue. But if these funds are spent partly or wholly as they will be, then the net monetary effect will depend upon the manner and timing of spending and the propensities to consume and save of the recipients of counterpart spending. The ultimate effects of counterpart spending will also depend upon the propensity to invest and import of the economy.

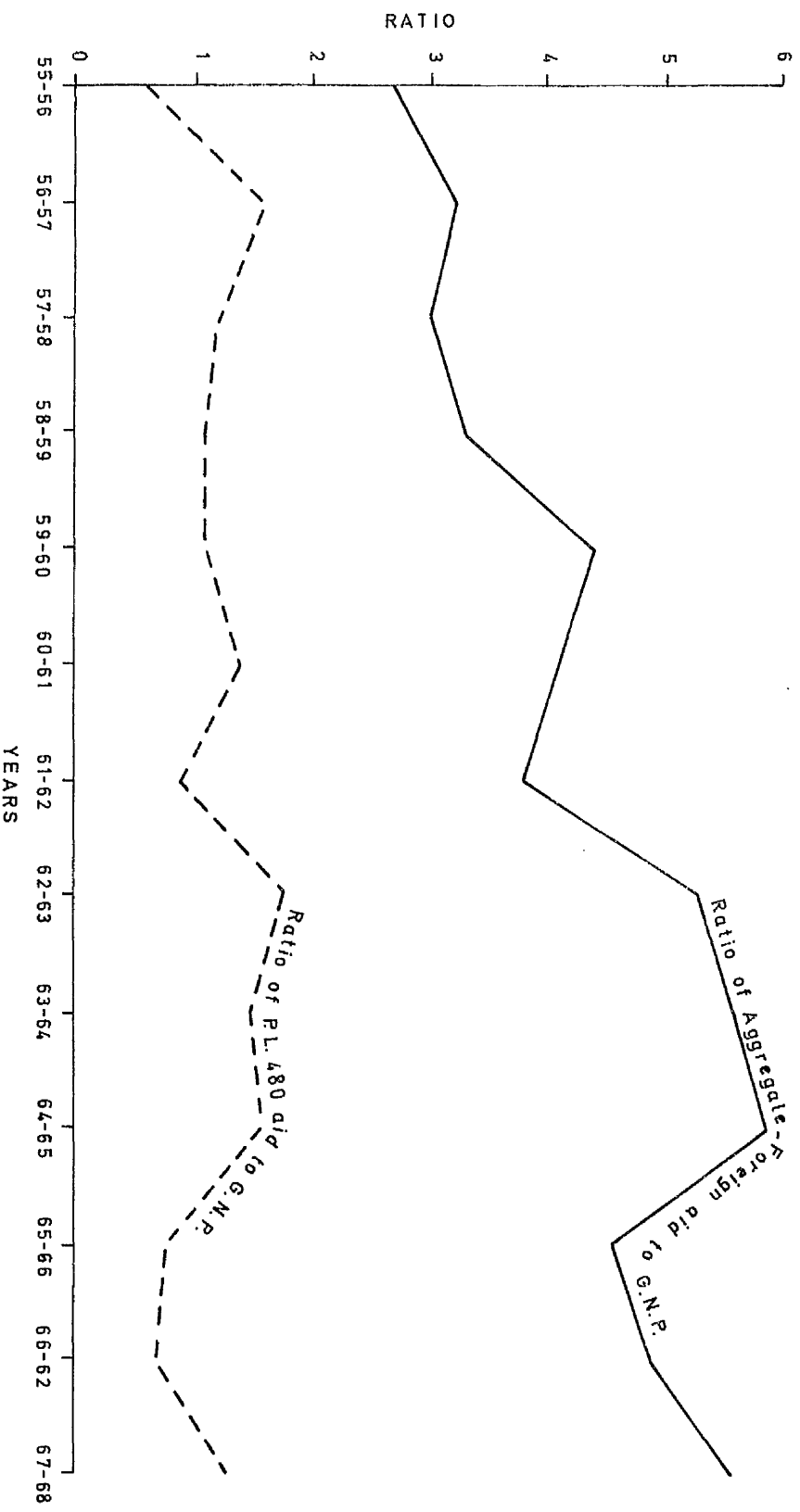
Let us first assume that counterpart funds are spent promptly and by their full amount. Experience has shown that this is hardly likely to be the case. Nevertheless, if this happens and if the recipients of government counterpart spending belong to the same class and have more or less the same propensities to consume and save as the purchasers of P.L. 480 commodities, then no net inflationary effects would be created. This is because, a prompt and full spending of counterpart funds would simply replace the money supply withdrawn from the public. The sale of surplus commodities in Pakistan tends to withdraw the money supply mainly from the poorer sections of the community who spend a larger proportion of their income on food consumption. The recipients of counterpart spending would also be mostly the poorer and newly employed people who will have more or less the same propensity to consume and save as those from whom the money supply had been withdrawn. Thus the redistribution of money supply will not affect aggregate spending to any significant degree and on this assumption, the money supply circulating round the domestic production as well as the propensity to consume of the community will remain more or less the same. Thus no net inflationary effect would be created. On the other hand, the country will have an increased

TABLE 63Aggregate P.L. 480 Imports 1955-68 (Million Rupees)

Year	Value Received	Percentage to G.N.P.
1955-56	145	0.6
1956-57	430	1.6
1957-58	358	1.2
1958-59	315	1.1
1959-60	370	1.1
1960-61	490	1.4
1961-62	320	0.9
1962-63	690	1.8
1963-64	634	1.5
1964-65	752	1.6
1965-66	420	0.8
1966-67	437	0.7
1967-68	836	1.3

Source: Government of Pakistan, Planning Commission Second Five Year Plan, Chapter 4, Table 5, Final Evaluation of Second Plan, Statistical Appendix Table 4.4 and Mid-Plan Review of Third Plan, Statistical Appendix, Table 5.4

CHART VI



supply of food and raw materials and the demand for these commodities would be satiated without a rise in their prices. Thus the community as a whole would be better off without any pressure on prices. In fact the inflow of basic commodities into the economy would have an overall stabilizing effect.

The other possibility is that the counterpart funds are spent with some delay and at a time when the P.L. 480 aid goods have been consumed. In this case, the counterpart spending would have net inflationary effects unless, by the time, the counterpart spending takes place, availabilities including domestic output and imports increase to match the spending. Unless this happens, the counterpart spending would exert pressure on prices as it would give rise to claims against new goods in the economy. Here again it is assumed that counterpart spending does not change the propensity to consume of the community to any significant extent.

So far it has been assumed that the counterpart spending is by the full amount of accumulations in a given year. But this may not be so. If in a given year, the counterpart spending exceeds accumulations in that year, this will have as much inflationary implications as deficit financing because in this case the money supply injected into the economy as a result of counterpart spending would exceed withdrawals from the public in the year concerned. Even on the assumption of an unchanged propensity to consume and prompt spending, this will have net inflationary effects. If counterpart spending is delayed and is in excess of accumulations in a given year, the inflationary effects will be further aggravated. On the contrary, if counterpart accumulations exceed spending, it tends to cushion the inflationary effects of Government borrowings and cash balance utilization for financing development projects. More generally

it may be said that in a seriously inflationary situation, counterpart spending would add to inflationary pressures but in most cases a selective counterpart spending would only help in breaking through the supply bottlenecks and in damping the general inflationary pressures in the economy especially on the food front<sup>6</sup>.

On the whole, the P.L. 480 imports into Pakistan and counterpart spending have tended to cushion the inflationary effects of Government's deficit financing operations. In an already inflationary situation and in view of the large quantum of deficit financing especially in the Second and Third Plan periods, the large quantities of foodgrains made available under the surplus commodities programmes have obviously brought a stabilizing effect on the food sector of the economy. As mentioned earlier, the domestic agricultural sector in Pakistan failed to meet the growing demand for food in the economy. In a situation of rising money incomes and expanding money supply, serious food scarcity could prove to be highly explosive. But as the P.L. 480 food imports greatly supplemented the domestic food supplies, the rise in food prices was much less than it would have been in the absence of this programme. On the other hand, in most years under study, accumulations in counterpart funds exceeded spending, thus withdrawing larger money supply than injected into the economy and thereby providing a cushion to Government's deficit financing operations. This is evident from Tables 29, 30 and 31 in Chapter IV. Thus, taken as a whole, the operation of counterpart funds and the availability of P.L. 480 supplies tended to dampen the otherwise inflationary situation in Pakistan. In the absence of this programme, the inflationary impact of development programmes would have been much more serious than actually experienced.

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6. Cf. A.E.Lachman, The Local Currency Proceeds of Foreign Aid, (Development Centre of O.E.C.D, Paris, 1968), P.69.

By stabilizing the price of an important wage-good, the P.L. 480 programme enabled the poorer sections of the community to raise their consumption of food thereby increasing their productive efficiency. It might also have helped them in increasing their savings by supplementing their real income. But the point is whether or not the P.L. 480 imports depressed the production incentives in the agricultural sector by holding down food prices. If it did, then the beneficial effects of the programme would have been partly washed off by the loss of domestic agricultural output. There is a common allegation against the P.L. 480 programme that it tends to depress the incentives for agricultural development in the recipient countries. This is on the supposition that the P.L. 480 imports turn the relative prices against the cultivators and thus the incentive to maintain or expand agricultural production is adversely affected. Some authorities including the staff members of the F.A.O apprehend that if P.L. 480 exports from the United States continue and are expanded, desirable and necessary agricultural development would not be possible in the receiving countries<sup>7</sup>. Edward Mason also writes about Pakistan:

"The availability of surplus agricultural commodities from the United States has certainly not been, in Pakistan and a number of other less developed countries, an unmixed blessing. During the 1950's, as we have seen, the terms of trade moved sharply against agriculture, and partly for this reason, the output of foodgrains increased less rapidly than the growth of population. P.L. 480 shipments had something to do with reducing farm incentives and, to

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7. Cf. T.W. Schultz, "Value of U.S. Farm Surpluses to Underdeveloped Countries", Journal of Farm Economics, Vol. 42, 1960, Reprinted in J. Bhagwati and R.S. Eckaus, Foreign Aid, Penguin Books, 1970.

some unquantifiable degree, must share the blame for the relative stagnation of agricultural output. On the other hand, if no surpluses had been available, the result would probably have been, in the Pakistan of the 1950's, a chaotic food price situation in which attempts at rigid controls would have been accompanied by black markets, large price fluctuations and great price differentials between markets"<sup>8</sup>.

The depressing effect of the P.L. 480 programme on local incentives for agricultural development is also reported by another writer:

"During the First Plan period in Pakistan (1955-60) it was argued, both inside and outside the Planning Commission, that considering the availability of P.L. 480, it would be a waste of scarce material and human resources to give a higher priority to agriculture"<sup>9</sup>.

Now it is obvious that the P.L. 480 food imports tended to lower the foodgrain prices than what they would have been in the absence of this programme. It has also been mentioned earlier in this study that the price elasticity of agricultural products in Pakistan is greater than zero. Thus private incentives to agricultural development might have been adversely affected. It may also be that the Government of Pakistan relied too much on availabilities under this programme for supplementing domestic output and, therefore, concentrated more on industrial development than on agricultural development. But two things are worth noting in this context. First, the depressing effect on domestic agriculture and reduced agricultural

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8. Edward S. Mason, Economic Development in India and Pakistan, (Harvard University Centre for International Affairs, 1966) P. 52.

9. Hal Mettrick, Food Aid and Britain, (Overseas Development Institute, London, 1969) P. 70.



output would have partly neutralized the effect of P.L. 480 programme on the food prices. Moreover, in view of the inflationary effects of deficit financing and development programmes, there was a pressing need for a countervailing force of additional imported supplies to keep the foodgrain prices at a reasonable level. The main contribution of imported surpluses is the provision of foodgrains at reasonable prices in the face of an otherwise highly inflationary situation. During the Second Plan period, approximately 15 per cent of West Pakistan wheat was supplied under P.L. 480 Title I. These imports permitted a stabilization of wheat prices in the Rupee 14 to 18 per maund range. Thus the industrial workers in urban areas were provided with a key wage-good at reasonable and stable prices. Price stability along with import liberalization were two important factors in permitting West Pakistan industry to grow at about 15 per cent per annum in the Second Plan period. On the other hand, in East Pakistan, the P.L. 480 commodities were used primarily in support of the Rural Works Programme which was designed to reduce the severe seasonal unemployment and underemployment in the rural areas of East Pakistan.<sup>10</sup>

By stabilizing the foodgrain prices, the P.L. 480 programme also enabled the Pakistani farmers to pay more attention to the production of cash crops. As the P.L. 480 imports introduced an element of stability in the foodgrain market of Pakistan, the farmers found an impetus to move into the production of higher valued cash crops by which they could hope to increase their incomes.

Moreover, by supplementing other types of aid to Pakistan, the P.L. 480 programme provided additional funds for purposes of

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10. Cf. W.P. Falcon and Carl H. Gotsch, "Lessons in Agricultural Development -- Pakistan" in G.F. Papanek (Ed.), Development Policy Theory and Practice, Op. Cit. PP. 305 - 307.

economic development. It also relieved the critical foreign exchange bottlenecks and gave support to the country's balance of payments position by providing foodgrains and other goods like oilseeds, dried milk and eggs, raw cotton etc. which in the absence of this programme would have had to be imported from the country's own foreign exchange resources. The diversion of scarce foreign exchange resources to the import of these goods would have reduced the import of capital goods and would have hampered real economic growth in the country. If these imports were not available, deficit financing and development programmes would have been much more inflationary than they actually proved to be.

## CHAPTER IX

### CONCLUSION AND POLICY IMPLICATIONS

#### 1. Summary of Findings:

This study indicates that Pakistan has experienced fairly significant inflationary pressures in the course of her economic development. Although the official price and cost of living indices are gross under-estimates, studies made by the Pakistan Institute of Development Economics and general observation of facts indicate that inflationary pressures have been fairly strong. East Pakistan has particularly experienced more inflationary pressures than West Pakistan because of inadequate supplies of food and frequent natural calamities. Often, the pace of inflation has been repressed by direct economic controls including food control and rationing and imports controls. If inflation had not been officially repressed and income velocity had been allowed a free play, price increases would have been much more pronounced than actually recorded by most official indices. Moreover, internal inflationary pressures were greatly diverted towards the balance of payments pressure and depletion of foreign exchange reserves despite the fact that current account deficits were greatly relieved by heavy capital inflows. Internal inflationary pressures were thus greatly cushioned by the external sector. When pressure on balance of payments and foreign exchange reserves is also taken into account, the over-all inflationary pressures in Pakistan become quite significant.

A large part of inflationary pressures have also been absorbed by relative wage rigidities. As expected in a labour surplus

economy with relatively less organised labour, money wages in Pakistan increased to some extent in the process of inflation and economic development but most of the time, they lagged behind the rising cost of living so that real wages were adversely affected. The real wages in East Pakistan were almost 25 per cent less than those in West Pakistan because of the higher rate of inflation, more unemployment and less organised labour in that part of the country. Due to this wage-lag in both parts of the country, inflationary pressures could not fully spread themselves and labour had to bear the brunt of inflation. In most modern economies, wages either serve as the initiator of inflationary pressures or at least play an active role in their transmission. This is true not only of developed countries but also of the Latin American countries where industrialization has gone far ahead of the less developed countries of Asia. In Pakistan, on the contrary, wages have tended to absorb a part of the inflationary pressures created in the process of economic development. On the other hand, high rates of profits in the industrial sector, especially in the early years of industrialization when competition was less, distorted the distribution of income in the urban industrial sector. There is a growing discontent in the country about increasing concentration of income and wealth and economic power in the hands of a relatively few. Urban income differentials are so wide that in Karachi top 5 per cent have incomes 27 times higher than the bottom 5 per cent. There has also been substantial redistribution of income from the rural to the urban sector as incomes in the agricultural sector have been greatly depressed by deliberate turning of the terms of trade in favour of industry and against agriculture through the development

policy. Domestic resources have been mobilized in Pakistan by restraining the growth of living standards of the poorest members of the society namely the rural masses.

Inflation in Pakistan<sup>has</sup>, however, not given much support to economic growth. The available evidence suggests that profits in Pakistan have not so much been determined by the rising prices as by the degree of competition. High rates of profit have often been associated with low rates of inflation and vice versa. Similarly savings and investment have been largely determined by the availability of imports of capital goods and raw materials rather than by the rising prices. When adequate investment opportunities were not available, savings tended to be diverted towards redundant consumption or hoardings.

Monetary expansion was quite significant in Pakistan most of the time under study. Government's deficit financing operations and the rising demand for bank credit in the private sector were the main factors responsible for it. Internal credit expansion was, however, greatly cushioned by the external sector which recorded significant deficits in most years under study. On the absorption side, the demand for money in Pakistan has been mainly of a transactions and precautionary nature and has thus been a stable function of the level of real income. But the marginal changes in money-income ratio can be explained in terms of the following factors:

(a) whenever direct economic controls including import restrictions were relaxed, spending opportunities increased and income velocity rose leading to a decline in the money-income ratio. Relaxations in import controls however increased the supplies of imports and supplemented domestic output. A part of the inflationary implications

of a rise in income velocity were thus absorbed by the rise in import supplies. Opposite happened when economic controls were tightened, (b) the money-income ratio has declined sharply after every peak and income velocity then rose significantly. This is because, the public in Pakistan seem to have adjusted their real cash balances to the desired level with some lag possibly of a year. Whenever monetary expansion was high and money balances accumulated with the public in excess of what they wished to hold, these were spent rapidly in the following year, thus resulting in a sharp rise in income velocity, (c) income velocity increased when crops were bad because the urban consumers tried to maintain their food consumption by increasing their expenditure on food while the rural producers maintained their consumption by reducing marketable surpluses.

The fiscal and monetary management in Pakistan suffers from serious deficiencies and needs considerable improvements. The tax receipts in Pakistan have increased at a fairly fast rate since the Second Plan period when attempts were made to mobilize larger domestic resources for financing economic development through the public sector and the income-elasticity of tax revenues has well exceeded unity, nevertheless tax potentialities in certain directions have not been fully tapped. In order to reduce the reliance on deficit financing, tax potentialities must be fully utilized and some suggestions have been made by us in this connection. On the other hand, non-development expenditures must be reduced as far as possible. However, since in a country like Pakistan, taxation cannot be pushed very far without a serious loss of private incentives, deficit financing is likely to continue as a source of public sector financing but attempts must be made to curtail it as far as possible.

As far as monetary management is concerned, the State Bank of Pakistan has failed to acquire efficient control over monetary expansion partly because it has largely been determined by the Government's deficit financing operations over which the Bank did not have much control and partly because it has not made full use of all the instruments of monetary control available to it. Inadequate monetary control was partly due to the fact that the Bank mostly relied on selective credit control measures. Of the other instruments used by it, changes in Bank rate and reserve requirements proved to be very ineffective. Scheduled banks' borrowings from the State Bank continued to rise in spite of a rise in Bank rate on three occasions as they were not high enough to control borrowings in the face of rapidly rising demand for credit in the economy. The Bank could probably control monetary expansion more successfully if it had used the over-all liquidity ratio of scheduled banks together with open-market operations as the principal instruments of monetary control. By regulating the scheduled banks' liquidity ratios, the State Bank could simultaneously manipulate their reserves and holdings of Government securities and thus monetary control would have been easier. It was also the responsibility of the Bank to develop the market for Government securities so as to make open-market operations more effective. By setting prices on Government securities and regulating their yields, the Bank could make open-market operations more effective.

However, it appears that factors like food shortages and foreign exchange difficulties, have been more important sources of inflationary pressures than any thing else. The agricultural sector in Pakistan has maintained a very low rate of growth while non-agricultural sectors have grown at a fast rate. Considerable pressure

was therefore exerted on food prices in the course of economic development and this appears to be the principal source of inflationary pressures in the economy. The lagging agricultural output was to a large extent the outcome of Government's agricultural policy rather than of any inherent inelasticities exhibited by this sector. Throughout the 1950's, agricultural prices were greatly depressed by the Government's food control policy and compulsory procurement of foodgrains at controlled prices together with high taxes on agricultural exports. Farm incentives were, therefore, greatly depressed and the price-elasticity of crop acreage being substantially higher than zero, this tended to depress agricultural output. On the other hand, industrial development was encouraged through liberal tax concessions and generous allocation to industry of scarce foreign exchange earned by agriculture. Import controls, high tariffs and Government's agricultural policy all resulted in adverse terms of trade for agriculture viz-a-viz industry. The outcome was an stagnant agriculture and a rapidly expanding industrial sector. The agricultural policy was somewhat modified in the 1960's; food control and rationing were abolished and export taxes on agricultural products were greatly reduced or abolished. These steps tended to encourage farm incentives and the agricultural sector then maintained a rate of growth almost double that of the 1950's. Nevertheless, in the face of rising per capita real incomes and a high rate of population growth, the excess demand for food continued in spite of heavy food imports both under the P.L. 480 programme and from the country's own foreign exchange resources. Food prices, therefore, increased significantly, contributing to the general inflationary pressures in the economy.



In addition to food shortages, chronic foreign exchange difficulties have also been greatly responsible for generating inflationary pressures in Pakistan's economy. In an under-developed economy, imports are an important source of supplementing the domestic output. These are needed both for development and non-development purposes. Foreign exchange shortages compel these countries to use import controls of various kinds. Instead of hitting at the basic problem of foreign exchange shortage and of using the appropriate exchange rate and commercial policies so as to increase the foreign exchange supplies to the maximum, trade restricting policies and exchange rate manipulations have been used as a device of meeting the situation. The exchange rate and trade policies used in Pakistan have done more harm than good to the foreign exchange position and import supplies. A highly over-valued official exchange rate with import licensing and multiple exchange rate systems have not only restricted imports and raised their prices but have also limited the possibilities of earning more foreign exchange. Official exchange rate has been adjusted only once in the history of Pakistan despite inflation and balance of payments difficulties, with the consequence that the exchange rate has always remained seriously over-valued. This has necessitated strict import controls and protective tariffs. Import restrictions and tariff protection raised the prices of imports and import substitutes by encouraging inefficient and high-cost industrial units in the country. In order to accelerate exports and to liberalize imports to some extent, a multiple exchange rate system was introduced in 1959 which gave an export subsidy to certain categories of exporters and provided foreign exchange to specified categories of importers at discriminating rates. The scheme tended to discriminate against

Pakistan's traditional exports but on the whole it failed to increase total foreign exchange earnings substantially. On the other hand, it raised the prices of imports allowed under the scheme enormously. In its net effects the scheme has proved to be more import substitutive than export accelerating. In her long-run interests, Pakistan must adopt a unified and realistic exchange rate but in fact an open devaluation has always been resisted for political reasons.

An important conclusion of our study is that economic development efforts in an under-developed country without a sound agricultural base and adequate foreign exchange supplies are bound to lead to pressure on prices and balance of payments. Sound agricultural development and adequate provision of foreign exchange are essential pre-requisites of stable economic development. Foreign capital inflows and commodity aid have, however, saved Pakistan from what could be considered a potentially serious inflationary situation. On the one hand, foreign economic aid has provided the country with necessary imports required for development which would otherwise have not been available and thus it greatly reduced the potential pressure on prices and balance of payments. Moreover, the P.L. 480 food imports have specifically provided a cushion for the inflationary implications of economic development programmes on food prices. The programme has provided the country an important wage-good as well as additional funds for development in the form of counterpart funds. The economic aid programmes have, on the whole, been greatly beneficial to stable economic growth in the country.

## 2. The Policy Implications:

This study suggests that economic development in an under-developed country like Pakistan must be backed by sound economic

policies directed to ensure stable and efficient economic growth. These include adequate agricultural development alongside industrial development, attempts to acquire adequate foreign exchange resources both by pursuing rational exchange rate and trade policies and by seeking to acquire larger foreign capital inflows, lesser reliance on inflationary methods of financing the public sector development programmes, increased tax efforts and improvements in the tax structure and lastly more efficient monetary control by the monetary authorities. These issues are elaborated further below.

There has been so much emphasis on industrialization in Pakistan that the resource potentials of the country have been grossly neglected. Agriculture which can provide substantial marketable surpluses to feed the non-agricultural population together with necessary raw materials for the growing industry and also some exportable surpluses has been unduly neglected. Government's agricultural policy including food control and high export taxes in the 1950's as also the sectoral allocation of development funds in different Plans have grossly discriminated against agriculture. Food shortages which are not so much due to inherent rigidities in the agricultural sector as to lack of proper incentives and investment in agricultural sector have caused serious pressure on prices. Food shortages have persisted despite heavy imports both under the P.L. 480 programme as well as on the country's own account. A trend rate of growth of about 3 per cent per annum in the agricultural sector since the Second Plan period is not enough for a country where population is increasing at an average rate of 2.7 per cent per annum and money incomes are also rising. Food being an important wage-good

specially deserves greater attention in the development programmes of the country. This can be done both by increasing public sector investment in the agricultural sector in future Plans and also by providing adequate incentives for private investment in agriculture in the form of effective land reforms, price stabilization measures etc. The food supplies in East Pakistan particularly need to be improved as this is a densely populated area with limited food resources, frequent natural calamities and transport bottlenecks.

The fact that adequate foreign exchange resources are extremely important for stable and rapid economic development in an under-developed country cannot be over-emphasized. This is because, in most of these countries, the domestic output needs to be supplemented by substantial imports. In the absence of these imports not only production would be adversely affected but also consumption would have to be further lowered. Foreign exchange supplies can be increased both by accelerating exports and also by seeking to increase foreign capital inflows. As far as the country's own foreign exchange earnings are concerned, among other things, the exchange rate policy has a lot to do with it. The Pakistan rupee has always remained seriously over-valued and this must have depressed the country's exports. Some recent studies on the price-elasticity of Pakistan's exports indicate that the elasticity of demand for major agricultural exports is high and statistically significant and the elasticity of export supply is also in most cases significant and greater than unity. A realistic exchange rate would presumably have increased the country's export earnings by pushing up both traditional and non-traditional exports. The multiple exchange rate system, in the form of export bonus scheme has done more harm than good to the country by discriminating against traditional exports and by raising

the prices of imports, thus creating an over-all import substitutive effect rather than an export accelerating effect. In our view, a unified and realistic exchange rate with some relaxation in import controls would more effectively serve the purpose of maintaining price stability and of improving the balance of payments position. The country's own foreign exchange earnings may be supplemented by foreign capital inflows as in the past and the P.L. 480 food imports may continue to supplement domestic agricultural output in order to meet the food requirements of <sup>a</sup> developing economy.

On the other hand, the existing reliance on deficit financing in the Government sector should be reduced as far as possible by cutting down non-development expenditure and also by raising additional tax revenues by re-orienting the tax structure. This is because deficit financing has played a significant role in generating the inflationary pressures next to food deficits. It is often suggested by economists that safe limits of deficit financing should be determined in the interest of price stability. However, in our view safe limits of deficit financing do not mean much in the context of Pakistan conditions because the size of deficit financing has been determined by political circumstances and foreign capital inflows. Nevertheless attempts can be made to manipulate its size by regulating the factors responsible for it as far as possible.

The responsibility of the State Bank of Pakistan in regulating monetary expansion is also considerably enhanced in view of the deficit financing operations of the Government and their impact on money supply. The Bank will have to demonstrate greater efficiency in monetary management particularly in those years when the Government is compelled to take resort to heavy deficit financing. Monetary

expansion on private account should be more effectively controlled in these years by using the instruments of monetary policy more efficiently.

It may be hoped that policy measures of the kind suggested above would ensure more stable and efficient economic development in Pakistan in the future.

S T A T I S T I C A L  
A P P E N D I X

TABLE S.A.1.Public Sector Development Outlays In First Plan

(1955-56 Prices, Million Rupees).

Sector	Plan Allocations	Actual Expenditure
Agriculture	1505	570
Water and Power	2697	1350
Industry, Fuels and Minerals	1622	780
Transport and Communications	1666	1170
Housing and Settlement	861	640
Education and Training	580	440
Health	288	160
Social Welfare and Manpower	133	30
Total	9352	5120
Expected Shortfall	1852	--
Net	7500	--

Source: Government of Pakistan, Planning Commission, The First Five Year Plan, 1955-60. (December 1957 p.15 Table 1) and M. Haq, Strategy of Economic Planning, (Table C-1 Appendix C.)



TABLE S.A.2Private Sector Outlays in the First Plan

(1955-56 Prices, Million Rupees)

Sector	Plan Estimates	Actual Expenditure
Industry and Mining	1750	1650
Transport and Communications	450	170
Housing and Settlement	800	890
Miscellaneous	300	-
Total	3300	2710

Source: M. Haq, Ibid., (Table 31, Chapter 5), and

(Table C-2 Appendix C.)

TABLE S.A. 3Second Plan Development Expenditures in Government Financed Sector

(Current Prices, Million Rupees)

Sector	Plan Allocation	Actual Expenditure
Agriculture	2515	1856
Manufacturing and Mining	1910	1627
Water and Power	4140	4341
Transport and Communications	2725	3072
Physical Planning and Housing	1885	1666
Education and Training	955	913
Health	370	400
Social Welfare and Manpower	120	75
Total	14620	13950

Source: Government of Pakistan, Planning Commission,

Final Evaluation of Second Five Year Plan,

(Chapter 3 Table IV).

TABLE S.A. 4Private Sector Development Expenditure in Second Plan

(Current Prices, Million Rupees)

Sector	Plan Estimates	Actual Expenditure
Agriculture	1155	3400
Industries and Commerce	3660	5300
Fuels and Minerals	550	550
Transport and Communications	1325	1600
Housing	1525	2510
Education	100	150
Health and Social Welfare	65	80
Total	8380	13590

Source: Government of Pakistan, Planning Commission Final Evaluation  
of Second Plan (Chapter 5 Table 1.)

TABLE S.A. 5Public Sector Development Expenditure in Third Plan

(Current Prices, Million Rupees)

Sector	Plan Allocations 1965-70 (Revised)	Actual Expenditure 1965-68
Agriculture	4115	1341
Water and Power	8047	3808
Industry, Fuels and Minerals	4105	1423
Transport and Communications	6711	2894
Physical Planning and Housing	2477	1049
Education and Training	2374	682
Health	1175	486
Social Welfare	90	29
Manpower	86	21
Rural Works Programme	1820	530
Total	31000	12263
Expected Shortfall	1000	--
Net Estimate	30000	--

Source: Government of Pakistan, Planning Commission Third Five Year Plan (Revised, March 1967), and Mid-plan Review of Third Plan, (Chapter 3 Table 11).

TABLE S.A. 6Third Plan Development Expenditure in Private Sector

(Current Prices, Million Rupees).

Sector	Plan Estimates 1965-70	Actual Expenditure 1965-68
Agriculture	4370	1297
Industry and Mining	9330	6795
Transport and Communications	3900	916
Housing	4000	2329
Miscellaneous	400	913
Total	22000	12250

Source: Government of Pakistan, Planning Commission, Third Five Year Plan, (Chapter VII), and Mid-Plan Review (Chapter 4, Table 11.)

TABLE S.A. 7

Balance of Payments, 1956-57 to 1963-64 (Million Rupees)

Item	1956-57	1957-58	1958-59	1959-60
A. Goods and Services	- 962.1	-1517.2	-621.5	-806.4
B. Transfer Payments	- 13.0	- 12.9	- 0.2	- 6.0
Current Account (A+B)	- 975.1	-1530.1	-621.7	-812.4
C. Private Capital Movements	35.9	22.5	1.4	7.2
D. Official Grants and Loans	729.7	1224.2	765.0	969.6
E. Short-term Liabilities	- 0.5	- 3.8	2.5	1.7
F. Reserve/Monetary Movements	228.8	289.3	-118.0	-204.5
G. Suspense Accounts	- 18.8	- 2.0	- 30.2	- 39.6
Capital Account	+ 975.1	+1530.1	+621.7	+812.4

TABLE S.A. 7 (Continued)

Item	1960-61	1961-62	1962-63	1963-64
A. Goods and Services	-1354.1	-933.4	-1586.1	-1872.0
B. Transfer Payments	- 5.4	1.6	4.0	80.6
Current Account (A+B)	-1359.5	-931.8	-1582.1	-1791.4
C. Private Capital Movements	18.8	1.8	- 3.1	- 16.0
D. Official Grants and Loans	1363.9	922.2	1904.9	1855.0
Short-term Liabilities	14.0	6.4	9.9	5.0
F. Reserve/Monetary Movements	16.3	102.7	- 314.0	121.2
G. Suspense Accounts	- 56.5	- 91.4	- 15.5	- 173.7
Capital Account	+1359.5	+931.8	+1582.1	+1791.4

Source: State Bank of Pakistan.

TABLE S.A. 8Balance of Payments 1964-65 to 1967-68 (Million Rupees)

Item	1964-65	1965-66	1966-67	1967-68
A. Goods and Services	-3012.1	-2305.2	-3049.4	-3010.3
B. Transfer Payments	1429.5	1058.1	1006.1	1400.6
Current Account (A+B)	-1582.6	-1247.1	-2043.3	-1609.7
C. Capital Transactions	1519.0	1319.5	1670.4	1576.8
D. Monetary Movements	288.3	- 87.9	425.7	121.3
(a) Gold, Dollar and Sterling Reserves	283.6	- 311.6	470.1	- 71.1
(b) Others	0.05	223.7	44.4	192.4
E. Balancing Items	- 224.7	15.5	- 52.8	- 88.4
Capital Account	+1582.6	+1247.1	+2043.3	+1609.7

Source: State Bank of Pakistan.



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